
MARCH 2009 QUARTERLY REVIEW

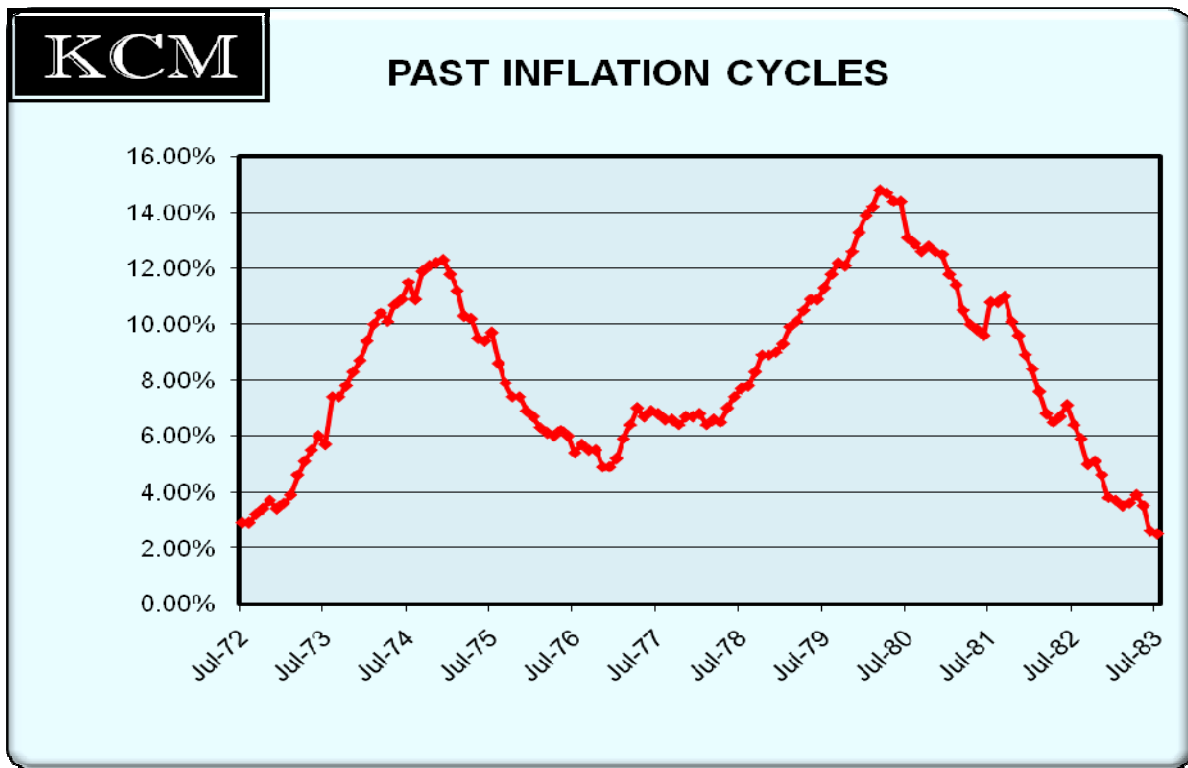
The roller coaster ride called “The Stock Market” continued during the first quarter of 2009. From December 31, 2008 to March 9, 2009, the S&P 500 was down 24.63%. From March 9th through April 3rd, the S&P 500 was up 24.71%. What changed? For starters, the second derivative, the rate of change decelerated. Retail sales, Mortgage Applications, Consumer Confidence, Housing Starts, Building Permits, Existing Home Sales, New Home Sales, Durable Goods Orders, and Domestic Vehicle Sales were all “less worse” than the month before and better than expectations. The economy remains weak, we continue to lose jobs, but the stock market is a leading indicator and is anticipating an economic recovery late in 2009 or early 2010. History tells us that the best buying opportunities in the past have come during the depths of a recession.

One of the most frequently asked question is, “how do I position my bond portfolio if I am worried about inflation a few years down the line?” There is almost universal agreement and concern that the unprecedented stimulus coming from governments and central banks around the world will eventually lead to a cyclical bounce in inflation. We have the same concern; in fact, we believe that it is the responsibility of governments and central bankers worldwide to bolster growth and **create some** inflation. The alternative, negative growth and deflation, is simply unacceptable.

The world we have known for the last sixty years is rapidly changing. We are moving from a world driven by caffeinated consumers and capitalists on testosterone (both on leverage!), lax regulation and globalization, to a world of deleveraging, more regulation and deglobalization (buy American products!). Easy money, leveraged consumers and Wall Street capitalists that were the drivers of our economic growth and economic excesses are being reigned in. So, what is the engine for future growth? We will certainly have to depend more on government and central bank stimulus. The question is, will the Federal Reserve’s three trillion dollar plus balance sheet and quantitative easing, plus another trillion or two of fiscal stimulus from the Obama administration, plus, to quote Ed Hyman, “a colossal global tsunami of policy initiatives,” rekindle growth and, also, uncomfortable levels of inflation? History tells us that central bank and government stimulus eventually turn economies, often

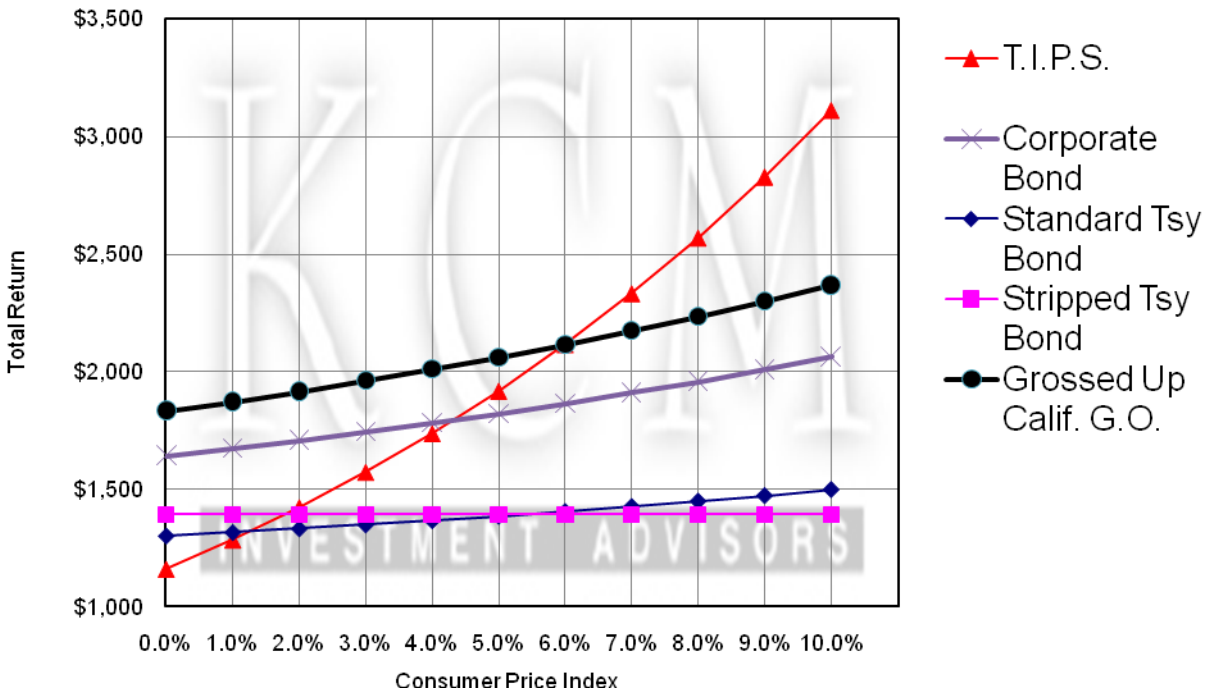
causing unsustainable economic expansion and uncomfortable levels of inflation.

The eleven-year period from July of 1972 to July of 1983 witnessed the two biggest spikes in inflation since 1947. The average year-over-year inflation rate for that eleven year period was 8.23%. We could certainly see a similar period in our future, but we think it highly unlikely over the next few years due to today's deleveraging, reregulating, deglobalizing world of castrated capitalists and cash starved, out of work consumers, who have been forcefully put on a credit lite, caffeine free diet. KCM believes the next expansion will push interest rates to about the same level we saw in 1999 or 1994, the two most recent interest rate peaks. Since 1983, the year-over-year inflation rate has peaked at about 6.3%. Long-term Treasury bond rates spiked up to about 8% in 1994.



The Bureau of Labor Statistics

\$1000 Investment at Maturity (4/15/19)



One recommendation we often hear to protect your portfolio against inflation is to buy TIPS (Treasury Inflation Protected Securities). The graph above shows you how TIPS work at various levels of inflation and what we think might be another good way to protect your fixed income portfolio in an environment where inflation peaks out at 6%-10%, but averages much less than that over the next ten years.

Currently, ten year TIPS give you a “real” return of about 1.4%. We don’t think this is an attractive starting yield and would like to see 3% or more. Currently, the year-over-year Consumer Price Index is 0.2%. In order to achieve some of the higher returns along the TIPS curve and get a better return than you can get from owning a ten year corporate bond, inflation would have to **average** 4%. In order to beat a ten year California General Obligation bond, inflation would have to **average** 6%. If we see another 11 year period like 1972 to 1983 then TIPS may make sense (best used in a tax deferred account), but, inflation has to accelerate very quickly and stay at an historically high level for an unusually long period of time. We think this is unlikely, especially starting with the CPI at 0.2%.

If you are worried about inflation, your investments are in a taxable account, you are in a high tax bracket and you live in California, it is hard to beat California General Obligation tax-free bonds.

To answer the question, “how do I position my bond portfolio if I am worried about inflation a few years down the line?” we suggest the following strategies:

- Accept lower yields and ladder some of your maturities in the 2-5 year area. These bonds will be maturing as inflation is increasing; you will have 100% of your principle to reinvest at higher yields.
- Take advantage of the unusually attractive yields in both the corporate bond market (for tax deferred accounts) and the California General Obligation municipal market (taxable accounts) and put a portion of those portfolios in the “10 year plus” maturity range. The break-even inflation rate is high enough verses TIPS so you should get a very competitive total return, even in a cyclical inflationary environment.
- Avoid the current bubble markets, Treasury bonds, Treasury bills and Money Market funds, with their very low yields.

To our valued clients, we thank you for your continued support and confidence. We continue to have the utmost confidence that our disciplined portfolio strategies will produce superior returns over the longer run. Managing money for our clients, friends and family is a responsibility we take very seriously.

KCM INVESTMENT ADVISORS LLC

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