

MARCH 2010 QUARTERLY REVIEW

Five Things to Know for the Next Four Quarters

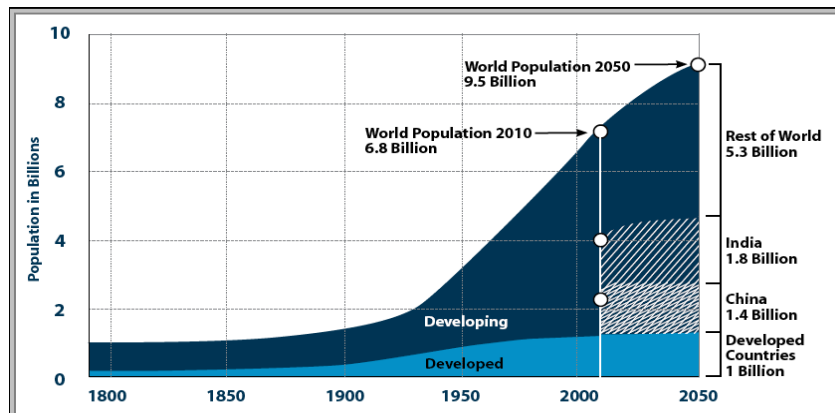
1. *Strong Global Growth Will Pull U.S. Real GDP*
2. *Inflation Is Still Far Off – Higher Rates Are Not*
3. *Unemployment Is Going Down*
4. *Taxes Are Going Up*
5. *State and Local Tax Receipts Are at an Inflection Point – Good for Municipals*

Global Growth

For most of the last century, U.S. domestic demand was the driver for commodity prices, semiconductor chip spending, and vehicle sales. Today we live in a new world order where growth and employment opportunities are more promising in emerging markets than in mature, advanced economies. The world still wants American machinery, technology, pharmaceuticals, movies, automobiles, university educations, and even our business models, and this time they want to take and keep them abroad. Emerging market growth is extraordinary. These countries are cash and asset rich, and *their domestic demand* is poised to drive global growth. The United States is still the largest economy on earth; our economic recovery is clearly underway and, in our opinion, likely to continue, pulled along by the extraordinary growth of the emerging markets.

This chart shows just how significant emerging market economies have become and what is forecast to be a long-term demand driver.

Source: United States Joint Forces Command



Strong Global Growth

- U.S. manufacturing sector expanded in March at its strongest pace in 5 ½ years.
- Exports and inventory rebuilding have led the rebound.
- The Institute for Supply Management reported that its gauge of industrial activity rose to 59.6 in March, its eighth straight month of expansion and the fastest growth since July 2004.
- Manufacturing activity expanded in all Federal Reserve regions in March.
- The Chicago Business Barometer expanded for six consecutive months.
- Manufacturing grew in spite of the negative economic impact from the worst winter weather in over half a century.
- Manufacturing surveys in China, Japan, Britain and 15 other countries all showed growth.
- Japan's Tankan Survey reports that business conditions are improving, the fourth consecutive quarter of improvement.
- Global steel production is soaring, back to its prior peak, and is up over 31% from its level at the beginning of 2009.
- Volkswagen just announced that it is increasing production of its Rolls Royce Phaeton due to growing demand from China.
- Commercial real estate prices are showing signs of bottoming.
- The Case Schiller home price index has risen for eight consecutive months.

Inflation/Employment

There is a lively polarity of opinion on the behavior of inflation as world economies recover and governments and central banks ponder their exit strategy from the unprecedented fiscal and monetary stimulus they showered on every corner of the earth.

Charts-Thomson Financial

The arguments for lower near-term inflation include the fact that the Fed's favorite inflation measure, Personal Consumption Expenditures, was



up just 1.3% in February, year over year. The *Wall Street Journal* points out that this was the smallest increase in six years and that it is trending lower. Capacity utilization was at 72.5% in February, up from a low of about 68%, but well below the cyclical highs of 80%-85% that we saw in prior recoveries. Unemployment remains high, making it hard for workers to demand wage increases and hard for manufacturing companies and retailers to raise prices. Credit remains tight and housing wealth low. Money supply growth has slowed and the *velocity of money* is at an historically low level.

The counter argument is that the tsunami of government stimulus has already led to a strong and sustainable economic



recovery, real demand is supporting inventory rebuilds, temporary employment is picking up, *permanent jobs are being added*, and unemployment is going down. Businesses and consumers are *expecting inflation*, thinking it is only a matter of time before actual inflation becomes a problem.

KCM believes that being vigilant about inflation makes sense, but KCM also believes that inflation worries are premature, especially in the developed world. Excess capacity in the labor market and manufacturing, limited retail and wholesale pricing power, tight consumer credit, low velocity of money, and the fact that inflation typically falls for some time after a recovery begins, all suggest that inflation will remain low for the next few quarters. We also believe that a sustained global recovery will eventually lead to higher interest rates as governments and central banks start to reverse their unprecedented easy money strategy and raise short-term interest rates.

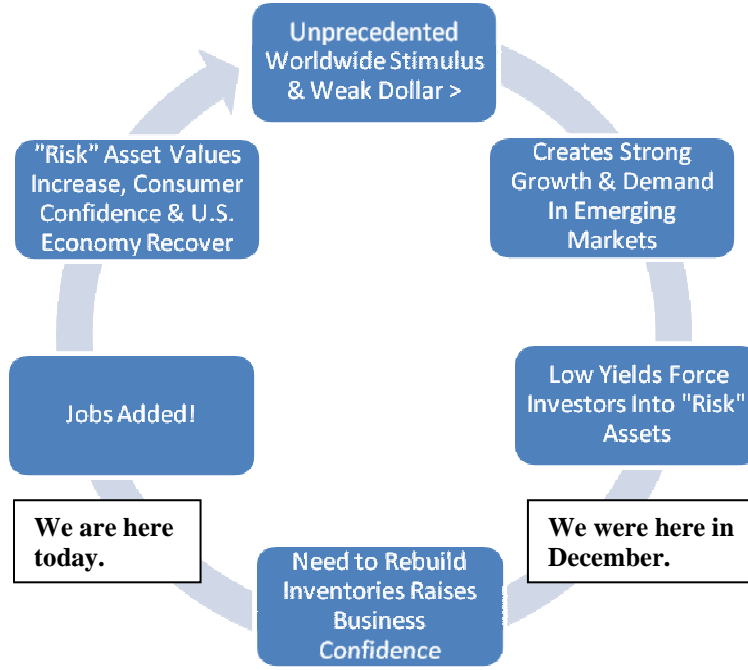
Stocks

A question posed by our clients is whether the stock market's 75% rise from the March 9, 2009 low was justified or just another asset bubble. The answer may be found in the question KCM asks everyday: What is the direction and level for corporate sales and earnings, and what is the public's appetite for equities over the next 9-18 months?

Corporate America is experiencing a sharp increase in profits because companies cut costs so aggressively during the downturn and productivity has increased at a record pace. The consensus earnings estimate for the combined S&P 500 companies is about \$94 in 2011. That means the S&P index is trading at about 12.6 times 2011 earnings, hardly bubble territory. The average Wall Street analyst's price target for the S&P 500 index is up about 8 ½% from today's levels. We are also seeing an increase in the appetite for risk assets over the past year, including stocks, because investors seem to be gaining confidence in the economy's direction and are tired of earning 0.01% on their idle cash.

For 15 straight months, fixed income funds have received the greatest money inflows on record (ICI), while equity funds have only recently seen positive flows. Corporate mergers and acquisition activity is rebounding. KCM's optimism is focused around the following: (i) growth of enterprise value led by revenue growth and margin expansion, and (ii) supply and demand factors for the broader equity market. This is positive and should continue throughout 2010.

The virtuous cycle we outlined in our December Quarterly is firmly in place, and we remain upbeat for equities.



Debt Markets

Historically, as the economy has gathered momentum, the Fed has started the process of raising interest rates. This process normally begins with “jawboning,” where the Fed starts to talk about monetary policy becoming “less accommodative” or “neutral” (the Fed considers a neutral Fed Funds rate to be 2% real, after inflation; currently the real rate is approximately -2%). This jawboning has started; in fact, the Fed raised the discount rate about six weeks ago.

The jawboning phase then turns to more aggressive action as economic growth continues and unemployment falls. We believe the catalyst for more aggressive Fed action will be a sustained decline in the unemployment rate, and March 2010 was the first month when that happened in approximately two years. It will likely take years to get to full employment, so the Fed will remain cautious until it sees this trend firmly in place.

State and Local Tax Receipts-California

Bloomberg published an article comparing California with Greece on April 1, 2010.

April 1 (Bloomberg) -- The bond market is showing that California is no Greece. Debt issued by California, the world's eighth largest economy, is outperforming Greece's bonds as funds say investors are betting that the lowest rated U.S. state's credit risk has been exaggerated. The cost to protect against California not paying its obligations is the lowest relative to Greece in at least 15 months, according to data compiled by Bloomberg.

Greece, with the European Union's largest budget deficit and an economy one-fifth the size of California's, is grappling with a debt crisis that's resulting in skyrocketing borrowing costs. The yield on the 10-year Greek bond rose to 7.16 percent on Jan. 28, the highest since October 1999, prompting European leaders to pledge aid to the nation. Even with an \$18 billion budget gap expected over the next 15 months, California sold \$3.4 billion in taxable debt last week at its lowest costs since November as overseas buyers purchased 30 percent of the securities.

Approximately 30% of nationwide municipal bond issuance is now Build America Bonds (BABs), subject to federal tax but state tax-free. In March, California came to market with a traditional tax-free issue and a taxable BAB issue. The net cost to California on the 30-year maturity, tax-free issue was approximately 5.65%. The 2040 BABs maturity's net cost to the state was approximately 4.86% (factoring the 35% subsidy from the U.S. Treasury), a material savings of about 0.80%. In March and April of 2009, California also sold a tax-free and a BAB issue, where the net savings to the state was about 1.10% on the long maturity bonds.

Municipalities and universities across the country are finding similar savings by issuing BABs, taking issuance away from the traditional tax-free market. Clearly, the more traditional taxable debt buyers (pension plans, sovereign funds) are getting comfortable buying BABs, punctuated by the fact that 30% of the last California issue was sold overseas. The longer the BAB program lasts, the more acceptance it will receive from traditional taxable bond buyers and the larger the percentage of traditional municipal borrowing it will become. Presently, the net cost to municipalities is less than issuing traditional tax-free bonds and the gross yield is higher than a traditional taxable bond buyer can get on a comparable rated corporate bond. This aberration will not last forever.

Will this trend create a shortage of tax-free bonds as tax rates creep up and the aging baby boomers move more of their assets into fixed income? Will this trend keep tax-free rates lower than they would otherwise be if all the municipal borrowing had to come through the tax-free market? We think so.

The Bloomberg article went on to say:

California's constitution gives debt service priority on the \$88 billion general fund, second only to education. The state has never missed a bond payment. Debt service as a ratio of the general fund is 6.7 percent, according to Treasurer Bill Lockyer. "It's interesting that there is this Greece analogy around, which I think is far too apocalyptic for the facts," Lockyer said March 30 in a Bloomberg Television interview. "As sovereign entities go, our debt is rather modest, so it seems to be an unfair comparison that creates doubts with investors."

California's \$18.6 billion deficit is about 1 percent of the state's \$1.8 trillion gross state product, while Greece's budget deficit equals 12.7 percent of its gross domestic product, the biggest deficit in the euro region.

California's outstanding tax-supported debt, about \$71 billion, is less than 4 percent of the state's gross domestic product. Greece's debt to GDP ratio is forecast to reach 120 percent in 2010, according to government figures, and yet Greece's sovereign debt is rated higher. Moody's Investors Service rates California's debt Baa1, its third lowest level of investment grade, while Greece is ranked two steps higher at A2.

Does this make sense? We don't think it does, and we are not alone. It has long been acknowledged that municipal bonds are stronger credits (rating for rating) than corporate bonds, structured bonds or even some sovereign credits. The three major rating agencies (S&P, Moody's, and Fitch), under pressure from a number of sources (including Congress) to change the way they rate municipal bonds, are in the process of doing just that. Moody's, for example, stated that it will be rolling out "mapped" ratings over a 4-week period beginning in mid-April to bring its ratings closer into line with ratings in other sectors. Moody's has said that no state general obligation bond will be rated less than A1. California's rating will go from Baa1 to A1. Fitch upgraded California to A- on April 5.

Tax Rates Are Going Up

The top federal tax rate is likely to rise to 39.6% from 35% as of January 1, 2011. Capital gains rates are likely to increase along with additional Medicare payroll taxes aimed at higher income taxpayers. State and Local tax rates are also going up, which along with increased revenue from an improving economy will be a positive for municipal bond credit quality.

Higher tax rates, improving credit quality, ratings recalibration by all three rating services, and the reduction in supply of tax-free issuance due to the popularity of the BAB program should keep tax-exempt municipal bonds attractive.

Conclusion

KCM believes the global recovery is well underway and, as a result, interest rates will edge higher, unemployment will edge lower, but inflation will remain muted in 2010. Stocks, while fairly priced, still offer compelling opportunities as our “Virtuous Cycle” moves along as planned. We have seen the low in tax rates for this cycle; bad for our bottom line but good for the U.S. Treasury and State and Local governments. We thank you for your business and your trust in KCM.

This material is presented solely for informational purposes and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation or solicitation to buy, sell or hold a security. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investment in securities, companies, sectors or markets identified and described were or will be profitable. This material has been prepared by KCM Investment Advisors LLC on the basis of publicly available information, internally developed data and other third party sources believed to be reliable. KCM Investment Advisors LLC has not sought to independently verify information taken from public and third-party sources and does not make any representation or warranty as to the accuracy, completeness or reliability of the information contained herein.