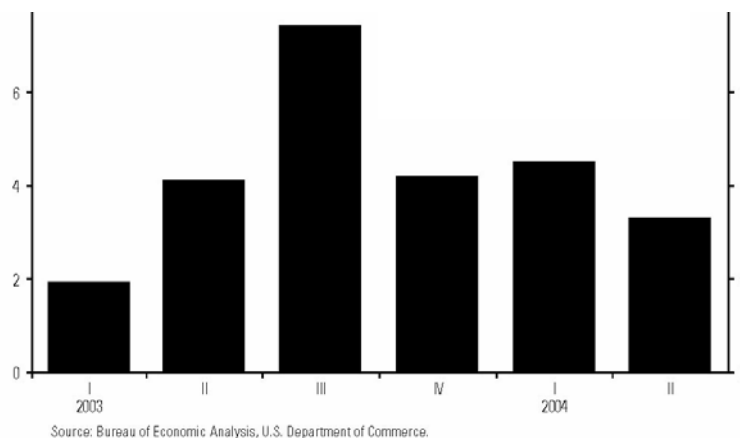


## September 2004 Quarterly Review

In the third quarter of 2004, the S&P 500 Index experienced a  $-1.9\%$  total return, the Dow Jones Industrial Average a  $-2.9\%$  return, and the Nasdaq Composite Index a  $-7.3\%$  return. Year to date, the total returns for the three indices were  $+1.5\%$ ,  $-2.1\%$  and  $-5.0\%$ , respectively. On the other hand, fixed income markets were relatively strong in the face of a robust economy and corporate profits. The U.S. Government 5-10 Year Index total return was  $+1.7\%$  for the quarter and  $+3.3\%$  for the year to date. High-grade corporate bonds achieved a  $+6.7\%$  total return for the September quarter and  $+6.7\%$  for the year to date, and the price of gold increased  $+5\%$  for the quarter and was flat for the year to date. The Consumer Price Index (inflation) rose at a  $+2.6\%$  rate for the twelve months ending August 2004.

The real Gross Domestic Product (GDP) growth rate for the second quarter of 2004 was recently revised for the second time to a  $3.3\%$  rate versus the  $4.5\%$  growth rate of the first quarter. The second quarter growth rate was a disappointment as real consumer spending rose at a meager  $1.6\%$  rate. It was obvious that rising oil prices, food, and health care costs had begun taking a toll on consumer spending and the optimism of stock investors. For fixed income investors, the Federal Reserve's interest rate hikes have boosted short-term maturities, while the longer term maturities have rallied sharply from their recent peak in yields that occurred in May.

**Real Gross Domestic Product  
Quarter-To-Quarter Percent Change, Annual Rate**



This recent rally in intermediate and long-term bonds was due to the realization that fear of the Fed's aggressive rate hikes should be tempered by more modest GDP growth rates. As the Federal Reserve has raised the Fed Fund's rate three consecutive times since June 30, 2004 (with the latest increase on September 21), the

Fed Fund's rate currently stands at 1.75%. Three-month Treasury bills closed the September quarter at a 1.72% yield, versus a 0.90% yield at the end of 2003, and the 10-year U.S. Treasury bond closed at a 4.12% yield, versus 4.26% at the end of 2003. This rise in short-term rates has created a flatter yield curve by nearly one percentage point since the end of 2003. Long-term yield volatility from current levels will continue as investors try to anticipate what the Fed's last tightening move will be, as well as the impact of rising oil prices on inflation and corporate profits. Short-term yields will continue to rise steadily, however, until the Federal Reserve reaches at least a neutral rate on the Fed Fund's rate (estimated to be slightly higher than the current inflation rate).

Recent statistics on the U.S. economy and the global economy are pointing to a modest slowdown from their peaks at the end of 2003. The forecast for U.S. growth in 2005 is 3.6% versus the 4.5% average rate for the two years ending March 2004. This more moderate rate should persist moving forward, however, as it is a more sustainable rate. Inflation, on the other hand, is edging up and is likely over the years to surpass the 2.7% average rate of the CPI since 1990. Currently, however, the CPI and core CPI (ex food and energy) are up 2.6% and 1.7% respectively for the past year. The current core inflation rate is probably not a realistic statistic in a sustained period of rising food, energy, and health care costs. Corporate chief financial officers (CFOs) seem to sense these cost issues more than Wall Street and the U.S. government. In a recent "CFO Outlook Survey" by Duke University's professors Harvey and Graham, CFOs predicted a 2.8% real GDP growth over the next 12 months, lower than Wall Street consensus. As the year unfolds, we will see whether Main Street knows more than Wall Street.

Facing high-level oil prices, the constant overhang of potential terrorist attacks, and upcoming election uncertainty, the markets simply need more clarity. In hindsight, 2004 should be viewed as a transition year in the re-pricing of stock multiples (due primarily to the increase in short-term interest rates by the Federal Reserve) offsetting strong profit growth. This transition also implies a cycle that is well along in the process of moving away from the consumer as its main growth engine to one that is dependent on global industrial growth.

As we at KCM stated in our June quarterly review, the stock market has struggled in a rising interest rate environment as it cannot get "multiple expansion" (higher price-earnings ratios) during these transition periods. A prime example of the extremes of the stock market this year are energy stocks, which were selling at below-market multiples last year while technology stocks were trading at a market multiple premium. Energy stocks have narrowed that gap this year and have outperformed technology stocks by 20 percentage points in the September quarter and by 33 percentage points for the nine months ending September 2004. These performance extremes are rare, especially since both sectors are expected to report an estimated 30% earnings-per-share growth rate in 2004. Stock multiples are simply continuing to converge!

Over the long term, however, corporate earnings growth is the most important factor to the stock market. S&P 500 operating earnings are estimated to increase 18% in 2004 and by 7-10% in 2005. While this “7%” rate will be a more “normal” historical rate, it is admittedly not as exciting as the high double-digit gains of recent years led by reduced debt levels and lower interest rates. Nevertheless, attractive companies in growth industries will always be around, and therefore KCM’s investment strategy will remain focused on finding and investing in these companies and sectors. In KCM’s fixed income portfolios, we are ready to extend maturities as the Federal Reserve continues to raise short-term rates in the months ahead. KCM, always mindful of market risk, remains both optimistic and opportunistic in our search for attractive returns in the face of ever-increasing challenges in today’s global economy.