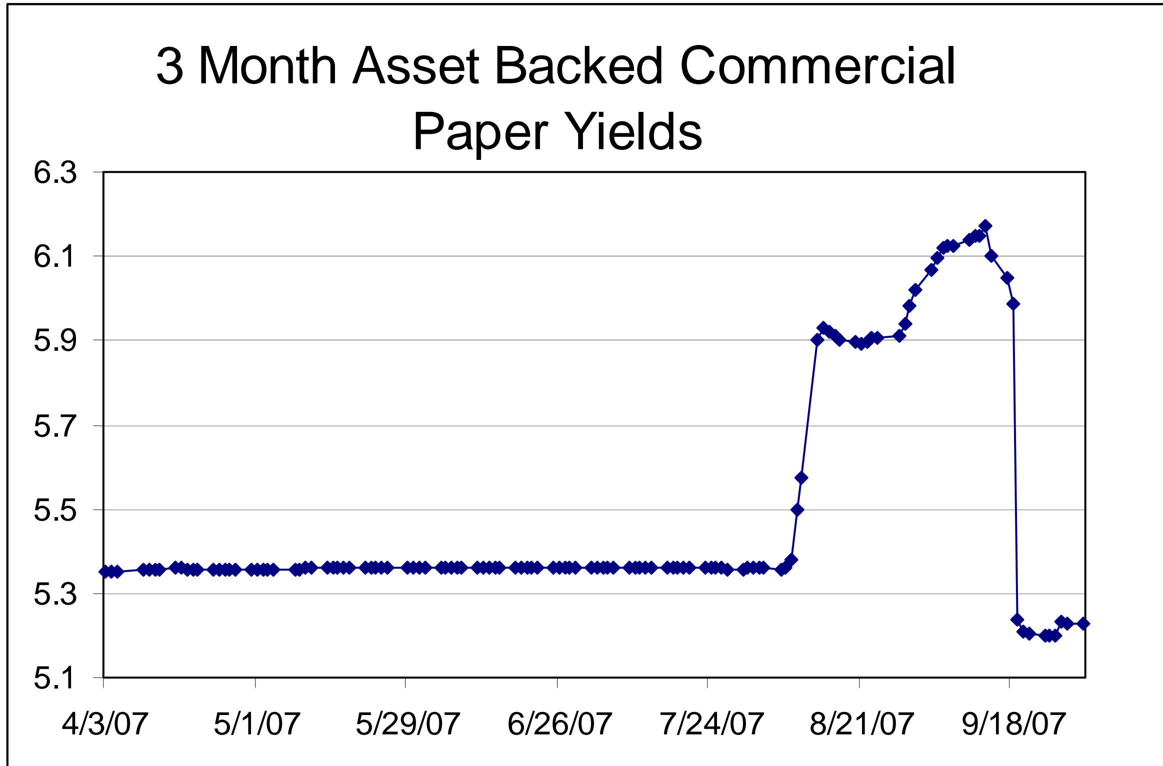
SEPTEMBER 2007 QUARTERLY REVIEW

The third quarter of 2007 witnessed very good returns, with the month of September turning in its best performance since 1997. For the quarter, the S&P 500 index rose 2.03%, the Dow Jones Industrial Average 4.19%, and the NASDAQ Composite 3.98%.

These returns were principally the result of the Federal Reserve cutting the Fed Funds rate and the Discount Rate by 50 basis points on September 18. This action was taken by the Fed to instill confidence in the economy and to offset the subprime turmoil in the credit markets. The subprime crisis caused the financial markets to shun any credits backed by mortgages and significantly increased financing costs in the Asset Backed Commercial Paper and Libor markets. (See graph on page 2) As a result, a flight to quality in the short-term end of the fixed income markets ensued. Two-year U.S. Treasuries rallied 88 basis points, from 4.86% to 3.98%. Short-term municipal bond yields declined slightly. The longer end of the US Treasury and Corporate Bond curves rose slightly, suggesting inflation fears remain.

The immediate reaction to the September 18th cut in short-term rates by the Fed was a dramatic stabilization and decline in yields in the Libor and Commercial Paper markets. (Graph on page 2) We also experienced a further decline in the dollar and a rise in the price of gold. It now takes $1.41 to buy one Euro, a new record. Two U.S. dollars are necessary to buy one British pound, and the Canadian dollar is now on parity to the U.S. dollar, matching its level back in 1976. Gold is now at $750, which is a 27-year high. U.S. exports and most stock markets are the prime beneficiaries of these trends.

*Fed begins to raise rates	*June 30, 2004	September 2007
Fed Funds Rate	1.00%	4.75%
10-Year U.S. Treasury Bond	4.70%	4.58%
Yield Curve (2 yr. to 10 yr.)	+190 bp spread	+60 bp spread
Inflation (CPI)	3.3%	2.0%
Real GDP y/y	4.5%	2.0% est.
Manufacturing PMI	61%	54%
Home Prices y/y	10%	-4.5%
Price of Oil	$36	$81.66
Price of Gold	$413	$750
S&P 500 Operating Earnings	25%	6-7% est.
S&P 500	1136	1527



Data from Bloomberg

THE ECONOMY

Despite fears that the housing crisis will kill the U.S. economy, few signs exist that this is occurring. In the second quarter, real gross domestic product (GDP) grew 3.8%. It now appears that the third and fourth quarters of 2007 will be reporting gains of about 2.2%. Real consumer spending, the main driver of the economy, continues to grow around 4%, a very attractive rate, supporting the economy and helping to offset the pressure on home prices. While residential housing activity is down about 15%, nonresidential construction is up 11%. An 8.2-month supply of unsold homes remains, but developers are unloading inventory at lower prices. The housing supply and rising default rates will simply take time to correct and as home prices drop, housing affordability improves. Employment gains, which are widely watched, remain positive as do wage gains. The labor market remains healthy.

An offset to the housing drag is the weak U.S. dollar. The current level of the U.S. dollar is improving the export growth of American companies' manufactured goods and services. We expect this trend to continue.

THE SUBPRIME MARKET/ THE LBO MARKET

When two Bear Stearns hedge funds got in trouble in June of this year, many market participants began to realize the breadth of the coming credit crunch. Too many investors had bought bonds backed by subprime mortgages based on credit ratings that were simply wrong. Billions of dollars of collateralized debt obligations (CDOs) were backed by these mortgages. They were sold around the world. In July, the rating agencies downgraded 1,300 subprime related securities.

Sloppy underwriting in the 2005-2006 period will ultimately cause billions of subprime-related assets to be sold, many by leveraged hedge funds and others under the pressure of margin calls, or repurchase demands in order to satisfy the minimum rating requirements from bond managers that are not allowed to own junk credits.

What this crisis really produced is the re-pricing of credit risk. For years, the risk premiums on junk bonds (below investment grade) have been very narrow in relation to prime credits. A surplus of global liquidity and low default rates sustained these narrow spreads. Hence, in the world of leveraged buyouts (LBOs), investment bankers and the private equity industry were able to resort to financing their merger and acquisition deals using "covenant-lite" debt which eliminates many traditional protections for creditors. This market, which grew $1.65 trillion in the second quarter of 2007, came to a screeching halt. Around $300 billion in deals, with already committed funding, have shown some signs of stress. This re-pricing of risk is healthy longer term, but it will keep the financial markets on edge as credit spreads are re-priced.

INFLATION

The current "core" inflation rate is about 2.0%, which is at the high end of the range of the Federal Reserve's stated target for core inflation (ex food and energy) of 1-2%. The Fed's action on September 18th suggests that they may be willing to see a slightly higher inflation rate to curb a potentially severe financial crisis and keep the economy on track. Was the rate cut potentially inflationary? The fixed income markets and the equity markets may be telling us that yes, it was. The easy money implication led to breakouts in gold, oil, agricultural products, a backup in long-term interest rates, and new lows in the U.S. dollar, all indicators that the markets are expecting higher inflation.

A weak US dollar is positive for trade and for corporate profits. However, a consistently weak currency imports inflation through higher priced imports. It also discourages foreign purchases of U.S. Treasury bonds potentially leading to higher interest rates and a higher cost to finance our fiscal deficit.

THE MARKETS

The Fed stated that "the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally." They followed by saying "today's action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from disruptions in financial markets." There is no indication that the Fed plans additional cuts in the months ahead. This would change if the credit crunch intensifies or the economy shows signs of significant weakness. It is also important to note that not only did the U.S. central bank supply liquidity during the recent credit crisis, but foreign central banks did the same, supplying liquidity world wide, which should help financial markets around the world maintain a positive bias.

The U.S. stock market showed its appreciation for the Fed's actions by breaking out of a trading band and rallying to market highs achieved earlier in the year. This response reinforces our view that further gains may be achievable in the fourth quarter. While some hit to third quarter and fourth quarter GDP is likely from the current credit turmoil, the U.S. economy and corporate profits look secure enough to weather a short-lived pull back from the consumer. The American business sector remains solid and global growth remains strong.

U.S. stocks are moving higher based on reduced recession fears and good earnings. There has been a shift to higher quality securities, large cap over small cap, growth over value, and industrial or business over the consumer. Earnings growth of around 6-7% in the next two quarters, versus nearly 8% in the first two quarters, will be a result of a downward pull from the financial and the consumer discretionary sectors. Good gains should continue in the industrial, material and energy sectors, along with a revival in the technology sector.

KCM remains positive about the U.S. economy's ability to continue to maintain attractive growth rates. Strong multinational companies are optimistic about achieving their targets as many foreign countries and their consumers are much healthier now than they were in the 1990s. Most of Europe and many of the emerging market countries have reduced their reliance on short-term external debt and have achieved pro-growth policies that are paying off. We believe the Federal Reserve is on the right track, the worst of the liquidity crisis is behind us, the US economy will slow down but not sink into a recession and that stocks have further upside during the fourth quarter. As for fixed income investments, the inflationary implications of a weak dollar and the steepening yield curve compel us to continue with our preference for building quality, short duration bond ladders.

We thank you for entrusting a portion of your investment needs to KCM. The third quarter was one of favorable returns which through continued expansion of our firm's resources and further development of our proprietary products, we hope to be able to repeat in the fourth quarter and beyond.