

September 2009 Quarterly Review

The Markets

September was the exclamation mark, capping off an outstanding quarter for equities. The S&P 500 and the Dow Jones both closed the quarter up about 15%. The quarter's returns make it the seventh best since 1895 and the best third quarter this decade. Five to 10-year Treasuries returned about 2.75%, while 20 to 30-year California municipal bonds had a total return of between 15% and 20% for the quarter!

When You Hear the Consensus Choir, Move Your Seat

The message from the choir and the vocal crowd of doomsayers is that we are in for an early 1980s-style *double-dip* recession. Sir John Templeton once said, "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." We have made it past the pessimism phase, but this is one of the most skeptical and polarized markets we have seen in years, creating extraordinary opportunities for the contrarian investor.

Structural difficulties have not vanished simply because the markets enjoyed a strong post-crash advance, but we believe good opportunities still exist, particularly with so much skepticism regarding the economy.

From our vantage point, those calling for the death of prosperity and a Japanese-like "lost decade" are precisely the same commentators who went into hiding in the first quarter of 2009, fearing widespread nationalization and the collapse of capitalism. This negative sentiment drove stock prices down to the March 9, 2009 lows that should go down in history as one of those twice-in-a-lifetime buying opportunities.

"Less Bad" Should Morph into "More Better"

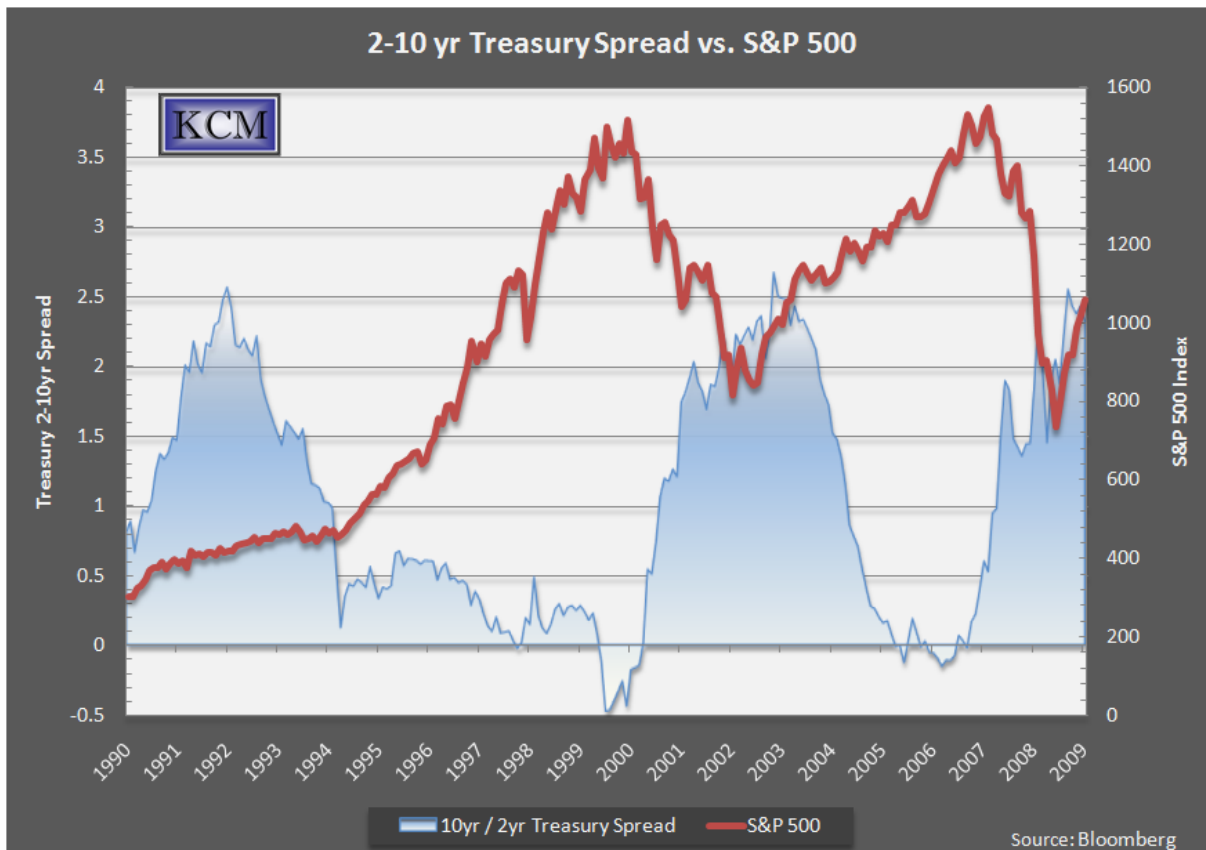
Looking ahead, we do not expect another 50% rally in equities or a further 500 basis point narrowing in corporate spreads. The global, synchronized attack to reliquify and the coordinated stimulus programs have made a difference. The economy should stabilize as corporate earnings produce greater clarity (confidence), individual and corporate investment risk gain momentum, and the trend for "less-bad" economic indicators morph into "more-better." This should be a positive for both high-quality corporate debt and equities. For the municipal bond markets, relief is seen for state and local budgets as borrowing costs have dropped to a 42-year low (Bloomberg) and investment-grade general obligations sell at yields not seen since May 1967 when LBJ was president.

Deflation Is Poison

The most vocal of the bond vigilantes have been shouting from the rooftops that government deficits will cause 1970s-like inflation, destroying the value of equities and bonds. The differing views on the deflationary/inflationary debate have become extremely polarized. We have noted in prior letters that, while many economists have been waving their arms about inflation, the greatest danger for the past two years has been deflation, exacerbated by the credit meltdown of September 2008. Our focus on deflation comes from the Center for Economic and Policy Research which estimates that \$14 trillion in global wealth evaporated last year. The Federal Reserve and central bankers in the Eurozone, Asia and the United Kingdom have created almost \$4 trillion in stimulus and asset-backed purchases to replenish the world with much-needed cash. Bernanke & Co. seem to have a solid understanding about the long-term devastation that deflation brings and are doing everything they can to stimulate spending, investment and growth. The alternative of allowing the “Great Recession of 2008-09” to unwind on its own into a period of prolonged deflation, is untenable.

The Yield Curve Story

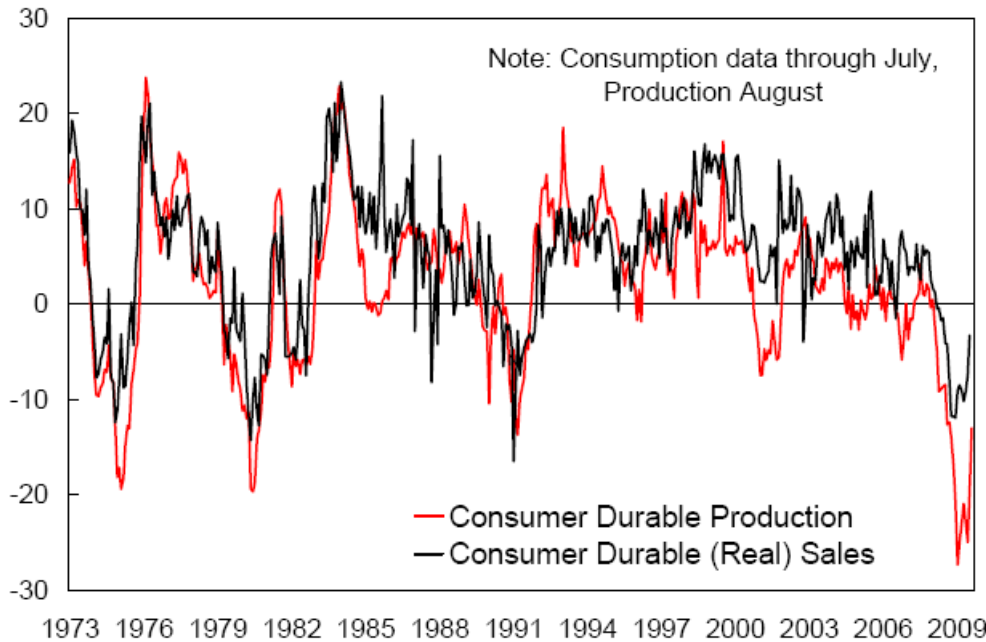
In prior letters, we have focused on the shape of the yield curve as a highly reliable barometer for future economic activity. The current 2 to 10-year Treasury curve is steep and should remain steep longer than in past recoveries. The following chart shows a very high correlation between a steep yield curve and the performance of the S&P 500. Is the shape of the curve predicting a three to five-year bull market?



Jobs

Consumption is outpacing production. Productivity improvement can only be stretched so far before employers start rehiring; the emerging inventory rebuild will be the catalyst for job growth.

Consumer Durable Consumption and Domestic Production, Y/Y%



Source: Federal Reserve Board and Bureau of Economic Analysis

As the World Goes, So Goes the USA

The key to our market forecast is the interconnectivity and international coordination lifting economic activity across the globe. What is underappreciated in most analysis is that for many years, America's contribution to Global GDP has been steadily declining. In the 1950's, the US accounted for over 55% of global GDP. By the 1980's that number had declined to approximately 40% and today stands at a mere 23%-30%, according to the IMF. It becomes most reasonable to conclude that what goes on outside our borders may be as important as what happens domestically.

Most investors today have never lived through a globally synchronized economic recovery. More importantly, today's analysts and academia alike have not seen a V-shaped U.S. recovery since 1982. While most analysts prefer to use the forecasting models of the shallow and jobless recoveries of 1991 and 2002, KCM believes it is likely that the emerging economies of Asia, South America and India could lead our domestic economy upwards, averting the much publicized *double-dip*. America's role in the world of providing

engineering, healthcare, technology, entertainment, communications and intellectual property to the emerging world will play a crucial part in our economic success.

Emerging Asia grew over 12% in the second quarter. Eurozone activity is just now turning positive and even London real estate prices have shown signs of strength. Earnings will grow in light of massive cost-cutting, surprisingly robust productivity increases, and low borrowing costs. Companies that have a positive correlation to global expansion such as semiconductors, metals, mining, machinery, communications and large cap banks will be of particular interest to KCM's investment strategy.

As we said in our March and June letters, Armageddon is off the table. Earnings comparisons will be easy to beat in the coming quarters, and compelling opportunities still exist due to the extreme polarization of opinion on everything from interest rates and the dollar to the growth of GDP.

We do not expect the recovery to be straight up. Credit shocks are always a possibility and pockets of structural weaknesses still exist, but this is the sixth financial crisis of our managers' careers and we believe the opportunities for success are real and attainable. Quality holdings in well-diversified portfolios will lead, and we look forward to serving as stewards of your investments in the quarters and years ahead.

KCM Investment Advisors LLC