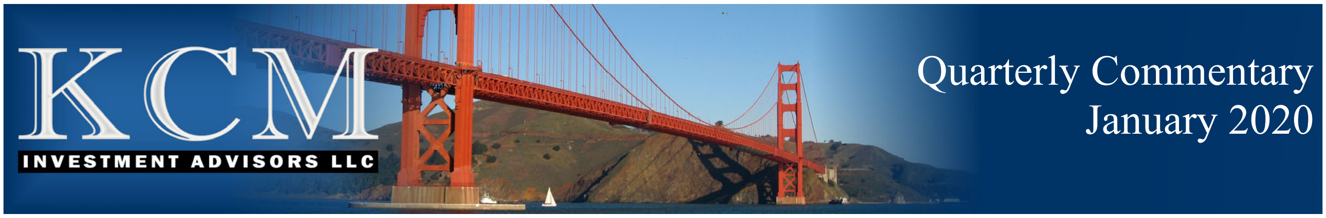


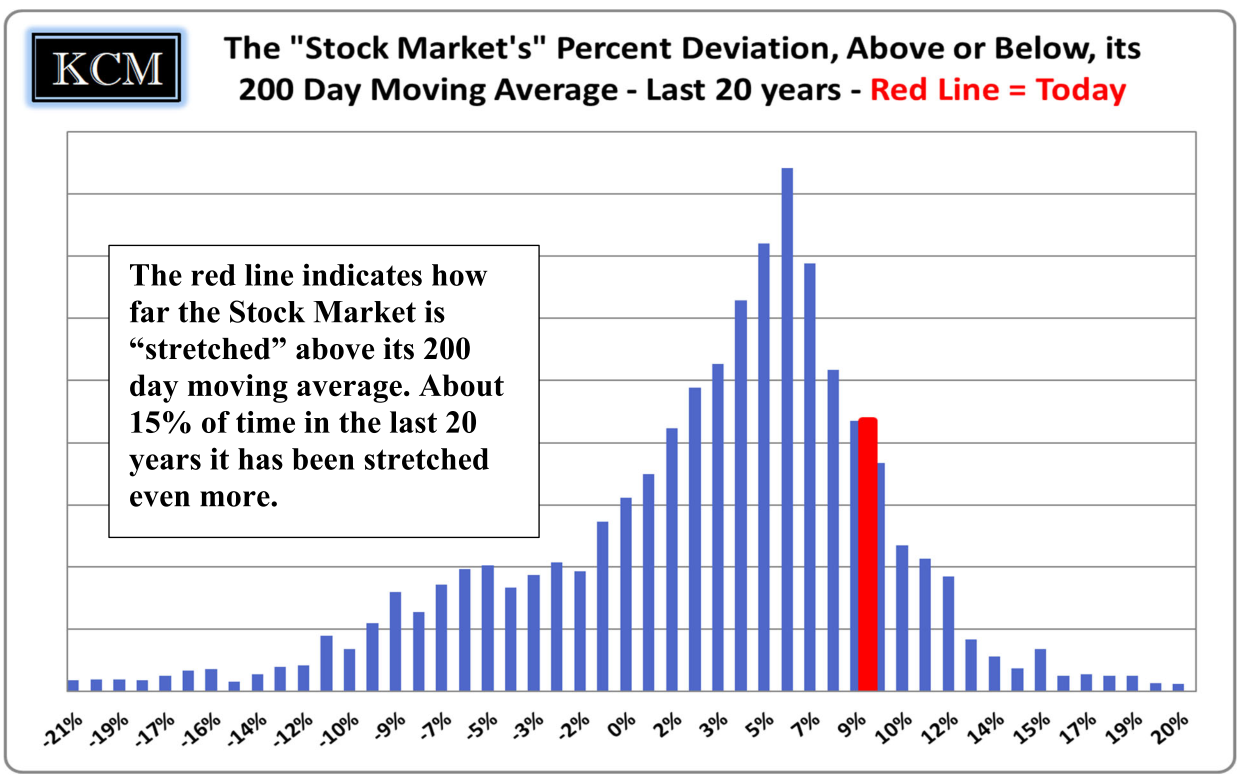
Questions for 2020

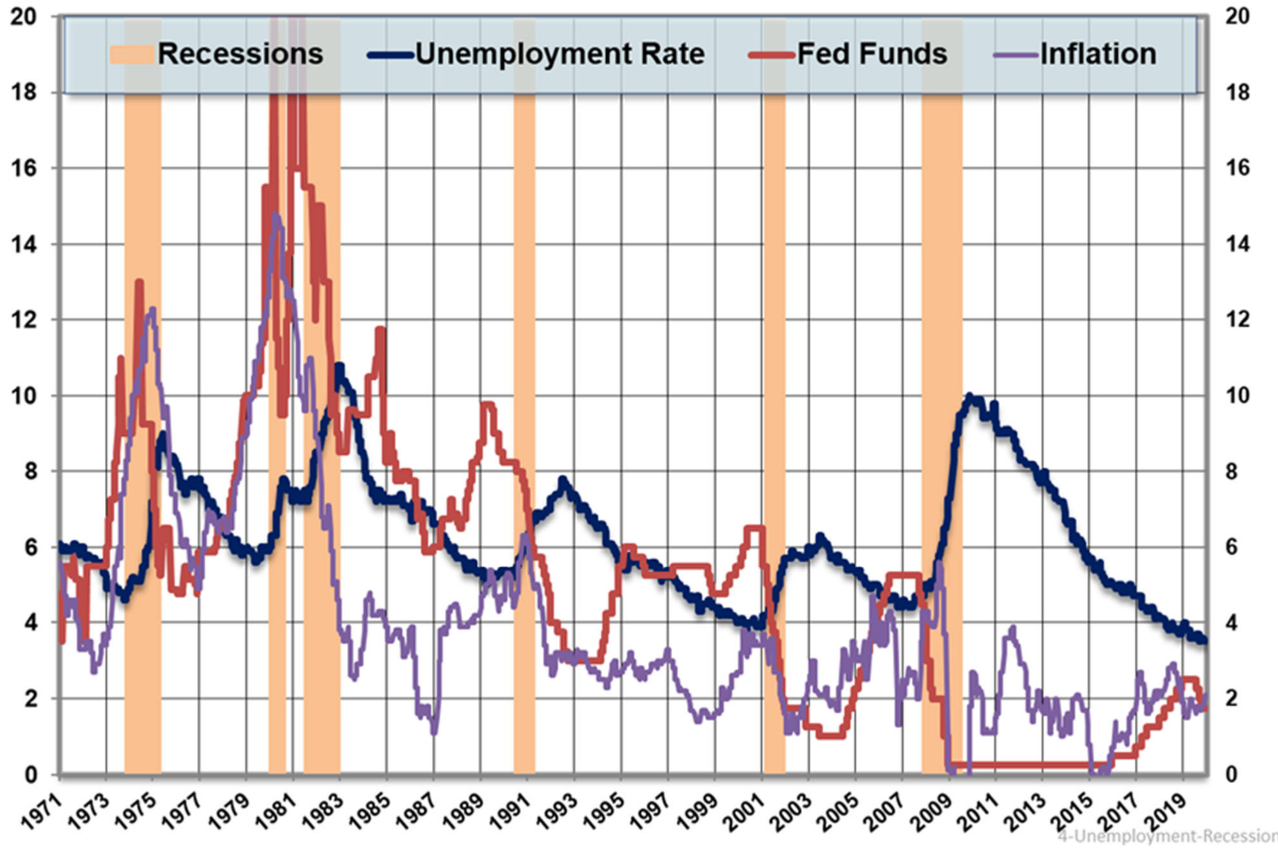
(And Why We Are Optimistic)

The stock market closed 2019 near its all-time high and demonstrated an unusually good fourth quarter that showed more than an 8% gain in the broad market indexes. So, we are asked, is the market too stretched near-term and possibly susceptible to a correction?

The chart below illustrates the extent to which the market has shifted above or below its 200-day moving average over the last 20 years. The red line indicates that only about 15% of the time has it been stretched this far on the upside. The chart also reveals that the market has been and can become even more stretched, although logic would indicate we may be due for a pause. The assassination of Qassem Soleimani is the latest headline to rein in the stock market's upward momentum and may be the catalyst for such a pause. Hopefully, the impact of this headline will fade just as other headlines have of late, for instance President Trump's impeachment, China trade issues, and Brexit.

Another question we are asked is whether we are close to the next recession or if we should expect more good times. To answer, let us first show where the economy is structurally.

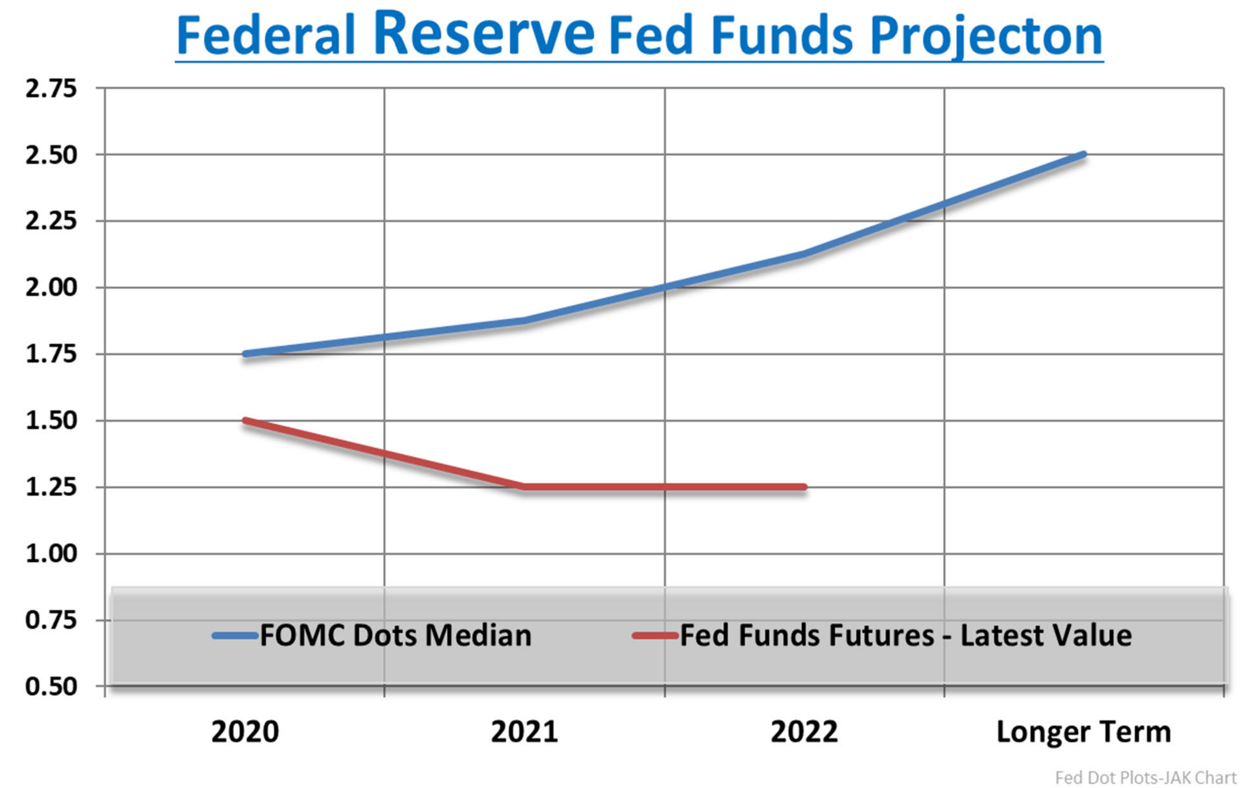




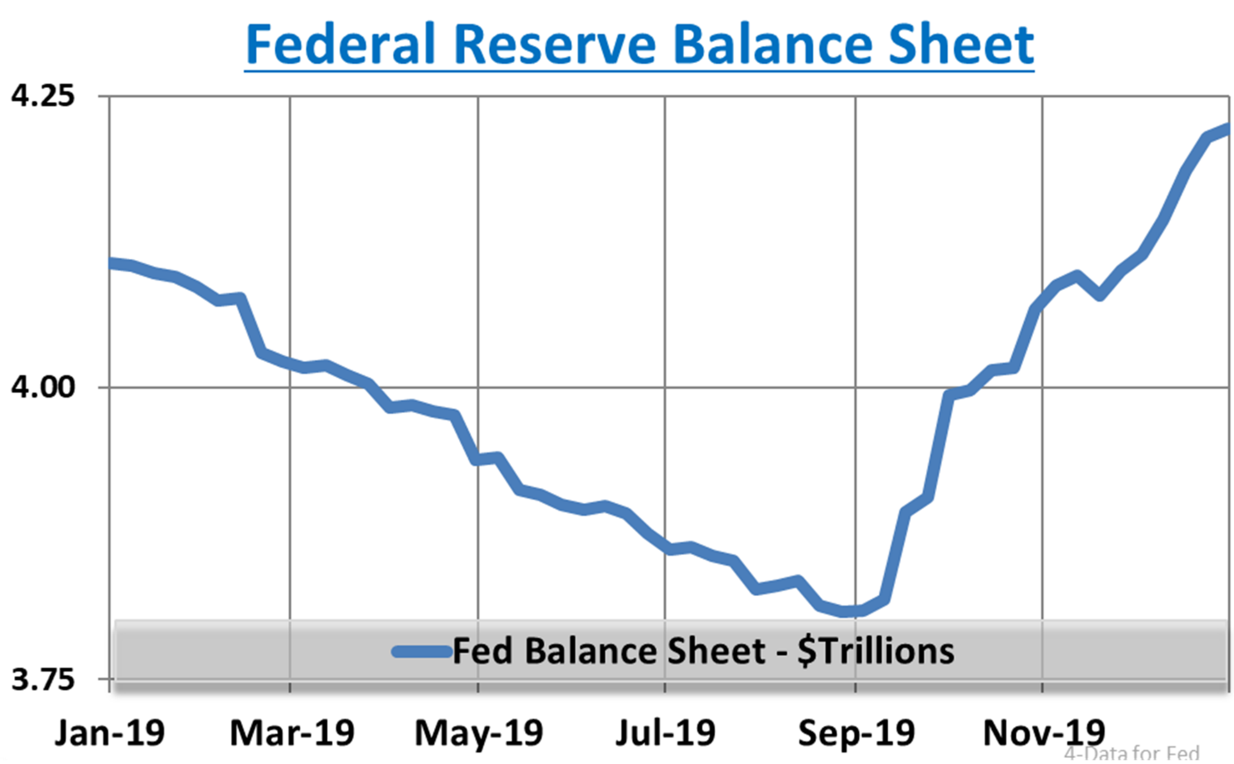
As the economic cycle matures, the unemployment rate declines, placing upward pressure on wages, one of the main drivers of inflation. When inflation rises, the Federal Reserve boosts the Fed Funds rate and cuts the size of its balance sheet to curb this upward inflationary pressure. The resulting higher interest rates increase the cost of doing business, enhance the attractiveness of bonds, and create a downward pull on the economy and stock prices, eventually pushing us into a recession (see chart above). So far, this cycle, with its historically low unemployment rates, has not seen the same upward pressure on wages or inflation, allowing the Fed to keep interest rates historically low.

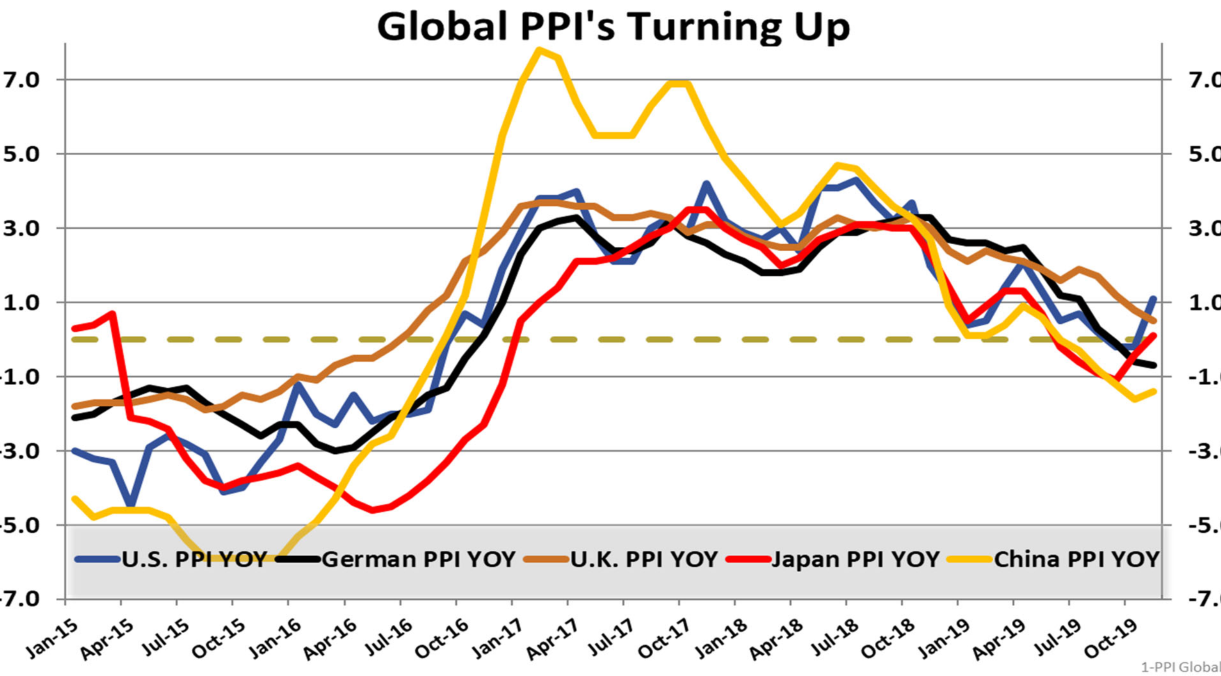
There are four reasons why we think the economy is less recession-prone than at similar points in past expansions:

1. **The FOMC's Fed Funds cuts starting in January 2019 (illustrated on page 3),**
2. **Its balance sheet increases starting in September 2019 (again, see page 3),**
3. **The stock and bond markets' outlook for acceptable inflation levels, and**
4. **A relatively stable Fed Funds rate for the next two years.**

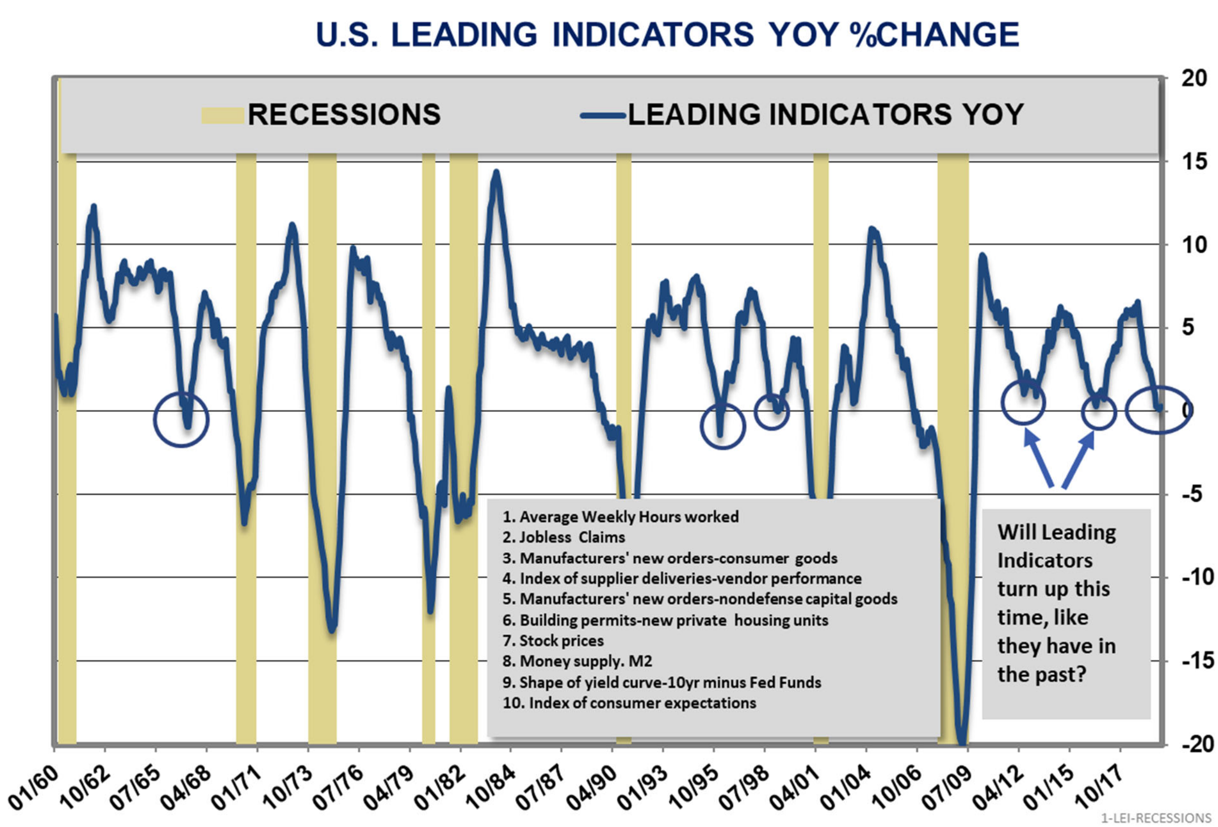


We see the Federal Reserve's actions in keeping relatively stable and low interest rates while increasing the size of its balance sheet as structurally positive for a continued economic expansion and market appreciation.



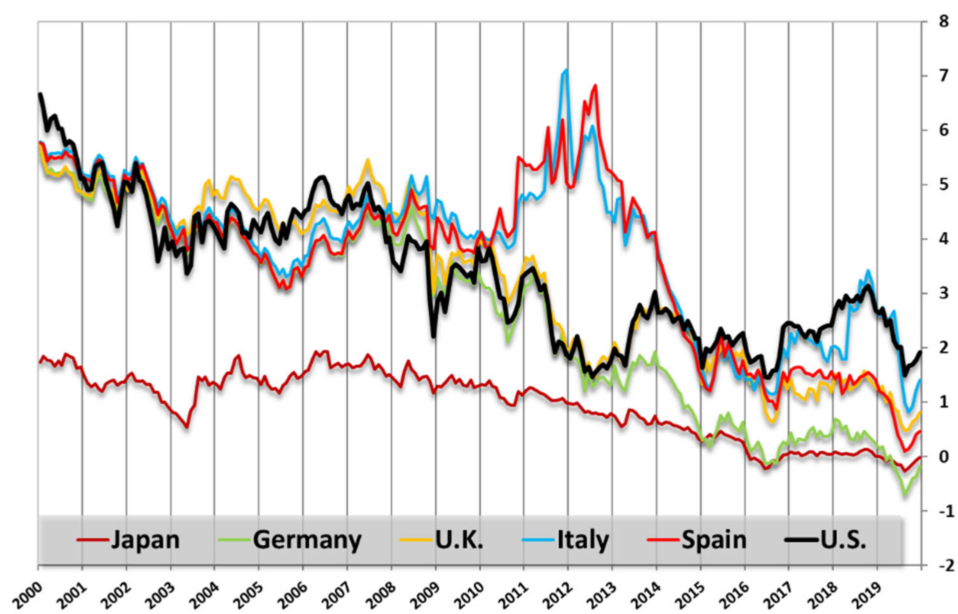


Global Producer Price Indexes (PPIs – chart above) have turned upward after a year-long decline. Some economists call the circled points in the next chart "mini recessions." We will be watching to see if the third "mini recession" since 2009 holds like the first two.



Interest rates, measured by the yield of the ten-year Treasury note, are lower than they were at the end of previous expansions. Low yields (borrowing costs) diminish the cost of doing business, which stimulates the economy, makes stocks more appealing, and helps postpone the next recession.

The same can be said for interest rates around the world: they are historically close to their all-time lows, and just like in the United States they are very stimulative. This should also help postpone the next recession. Note that ten-year government bond yields in Japan and Germany are still negative!



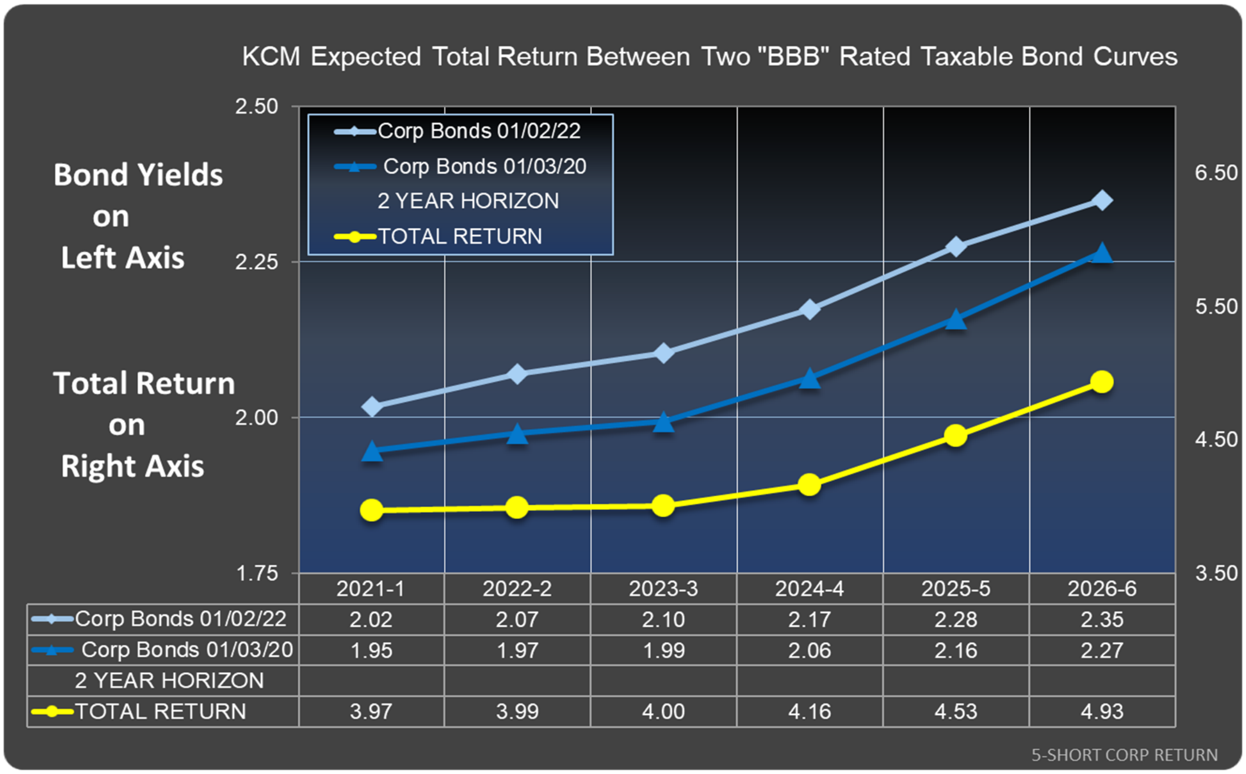
FIXED INCOME

KCM	Before & After-Tax Yields					
Call or Maturity	Calif. + Fed. Tax Brackets Federal Tax Brackets	50.3% 37%	47.3% 35%	43.3% 32%	34.3% 24%	31.3% 22%
8-10 Years to Call	CA Muni - Tax Free	1.97	1.97	1.97	1.97	1.97
	CA Muni Taxable Equiv.	3.96	3.74	3.47	3.00	2.87
	Natl Muni Before-Tax	1.99	1.99	1.99	1.99	1.99
	Natl Muni After Calif Tax	1.73	1.74	1.76	1.78	1.80
1-3 years	CA Muni - Tax Free	0.88	0.88	0.88	0.88	0.88
3-5 Years to Maturity	Corp Bond Before-Tax	2.32	2.32	2.32	2.32	2.32
	Corp Bond After-Tax	1.15	1.22	1.31	1.52	1.59
5 Years to Call	Preferreds Before Tax	6.00	6.00	6.00	6.00	6.00
	Preferreds After-Tax	2.98	3.16	3.40	3.94	4.12
10 Year Maturity	Treasuries Before-Tax	1.78	1.78	1.78	1.78	1.78
	Treasuries After-Tax	1.12	1.15	1.21	1.35	1.39

KCM	Living in Federal Tax Only State					
Call or Maturity	Federal Tax Brackets	37%	35%	32%	24%	22%
8-10 Years to Call	CA Muni - Tax Free	1.97	1.97	1.97	1.97	1.97
	CA Muni Taxable Equiv.	3.13	3.03	2.90	2.59	2.53
	Natl Muni Before-Tax	1.99	1.99	1.99	1.99	1.99
	Natl Muni Taxable Equiv.	3.16	3.06	2.93	2.62	2.55
3-5 Years to Maturity	Corp Bond Before-Tax	2.32	2.32	2.32	2.32	2.32
	Corp Bond After-Tax	1.46	1.51	1.57	1.76	1.81
5 Years to Call	Preferreds Before Tax	6.00	6.00	6.00	6.00	6.00
	Preferreds After-Tax	3.78	3.90	4.08	4.56	4.68
10 Year Maturity	Treasuries Before-Tax	1.78	1.78	1.78	1.78	1.78
	Treasuries After-Tax	1.12	1.15	1.21	1.35	1.39

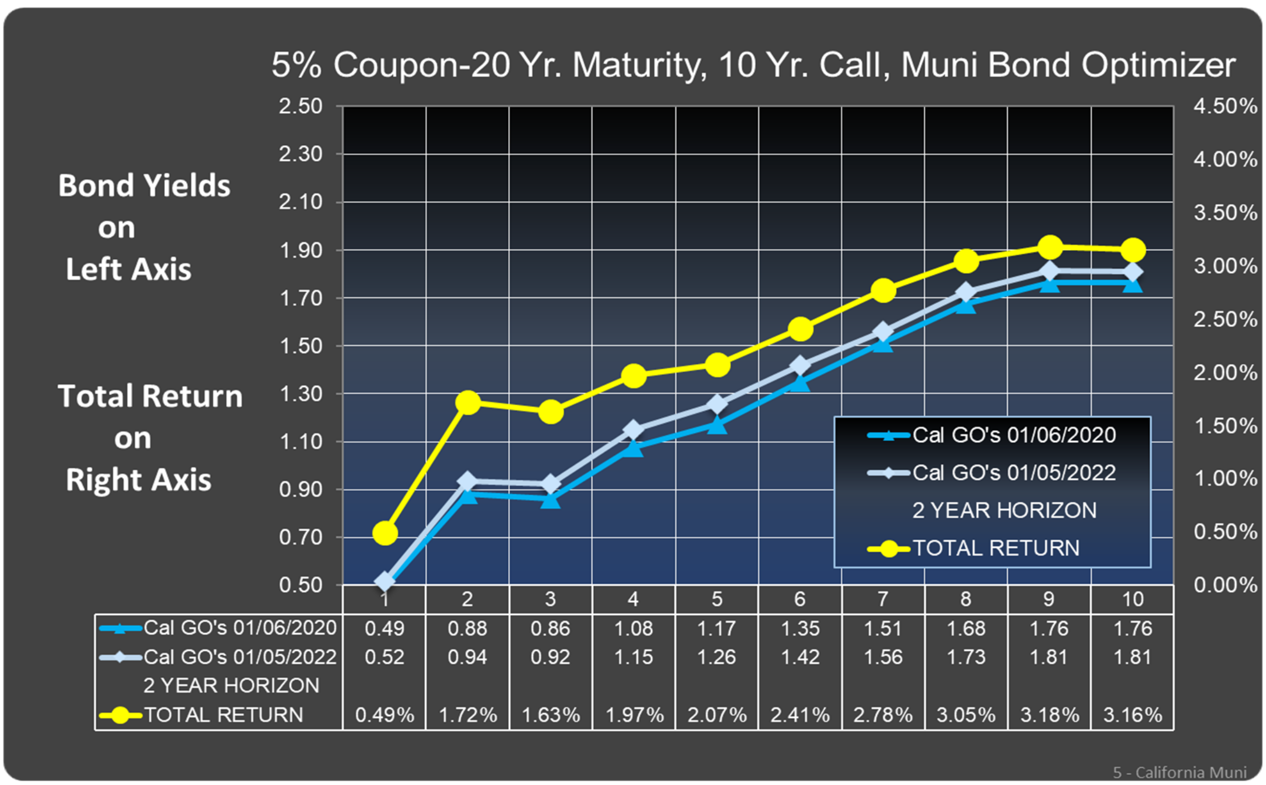
The tables above compare the current investment alternatives, before and after tax, in fixed income securities. For years, we have been recommending Preferred stocks as an attractive fixed income addition to portfolios, and we still do. The pretax yield is more than double our expected return on corporate bonds and about 50% higher, after tax, than what municipal bonds provide.

But, constructing a Preferred stock portfolio is an art. These vehicles have perpetual or long maturities, and most have only five years of call protection. The credit quality must be acceptable and the coupon high enough to give investors some protection in a rising interest rate environment. This can be a tall order, but well worth it, in our judgment. **Preferred stocks for a portion of a fixed income portfolio remain as one of our best ideas.**



	2021-1	2022-2	2023-3	2024-4	2025-5	2026-6
Corp Bonds 01/02/22	2.02	2.07	2.10	2.17	2.28	2.35
Corp Bonds 01/03/20	1.95	1.97	1.99	2.06	2.16	2.27
2 YEAR HORIZON						
TOTAL RETURN	3.97	3.99	4.00	4.16	4.53	4.93

Already near historic lows, interest rates are likely to head even lower in the short run as central banks worldwide continue to trim their benchmark rates to stimulate their economies. Two years from now, we expect that trend will change direction, so our projected returns for corporate and municipal bonds assume slightly higher rates.



	1	2	3	4	5	6	7	8	9	10
Cal GO's 01/06/2020	0.49	0.88	0.86	1.08	1.17	1.35	1.51	1.68	1.76	1.76
Cal GO's 01/05/2022	0.52	0.94	0.92	1.15	1.26	1.42	1.56	1.73	1.81	1.81
2 YEAR HORIZON										
TOTAL RETURN	0.49%	1.72%	1.63%	1.97%	2.07%	2.41%	2.78%	3.05%	3.18%	3.16%

Stock & Bond Market Valuations								
12 Months Ending	Peak 2000 3/31/2000	Peak 2007 9/28/2007	Bottom 2009 3/31/2009	CY 2015 12/31/2015	CY 2016 12/31/2016	CY 2017 12/31/2017	CY 2018 12/31/2018	Current 1/6/2020
Price/Earnings	28.89	17.10	14.38	18.78	20.54	21.81	16.52	21.60
Price/Cash Flow	16.74	20.06	5.18	10.67	12.31	14.31	10.72	15.52
Price/Sales	2.25	1.64	0.82	1.85	1.98	2.20	1.91	2.36
Price/EBITDA	10.69	6.92	5.15	10.47	10.58	11.43	9.98	9.92
Dividend Yield	1.10	1.82	3.59	2.15	2.09	1.89	2.15	1.92
Fed Funds	6.00	5.25	0.25	0.50	0.75	1.50	2.50	1.75
3 Month T-Bill Yield	5.87	3.80	0.20	0.16	0.50	1.38	2.35	1.52
Ten Year Treasury Bond Yield	6.00	4.59	2.66	2.27	2.44	2.41	2.68	1.78
Leverage Ratio-Lehman	35.50	32.00						
Leverage Ratio-Goldman	24.80	28.40	19.00	11.46	11.47	12.69	12.53	12.22

Stock market valuations are not excessive compared to the last five years (remember, the stock market was down about 20% in fourth-quarter 2018, explaining the lower year-end P/E number). **Still historically-low bond market yields and much reduced dealer leverage should support economies and equity markets worldwide.**

We Are Optimistic!

1. The stock market may be slightly stretched and, one might logically think, due for a pause. But…
2. Central bankers worldwide are doing what they can to stimulate their economies, primarily keeping interest rates low.
3. Low yields (borrowing costs) decrease the cost of doing business, which stimulates the economy, enhances the attractiveness of stocks, and helps postpone the next recession.
4. Preferred stocks for a portion of investors' fixed income portfolios remain one of our best ideas.
5. We are confident KCM's Dividend Blue Bloods portfolio will continue to shine.

We wish you a happy and healthy New Year and, as always, we thank you for your trust.

Jay Kellett, Founder and CEO, and your KCM Team

***All the graphs produced by KCM; data from Bloomberg.**