Whip Inflation Now!

(Gerald Ford Said It in 1974, and We Say It Today)

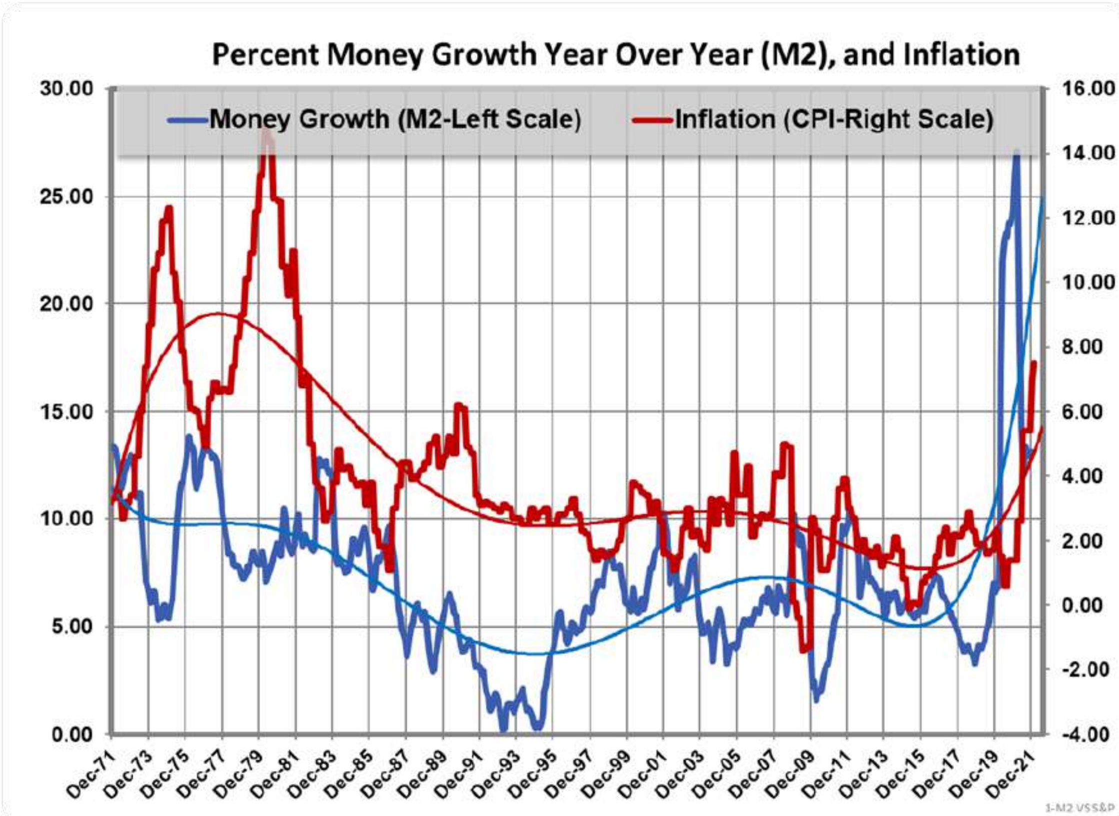
In 1974, then-President Gerald Ford pronounced inflation "public enemy number one." We think it still is. The charts below illustrate the current economic cycle, how it started, where we are now, and where we are likely to go over the next two years. We see full employment, but rampant inflation is forcing the Federal Reserve to focus on stabilizing prices by embarking on a period of quantitative tightening, reducing its purchases of Treasury bonds and Mortgage-Backed securities, and raising short-term interest rates. The eventual result should "Whip Inflation," slow economic growth and trim risk asset appreciation.

Money (M2) Growth Coming from The Federal Reserve and Washington → **Leads to: Commodity Price Increases Oil up 500% Since 2020** → **Leads to: Producer Price Increases. PPI up 13.8% Year Over Year** → **Leads to: Consumer Demand and Price Increases. CPI up 7.9%**

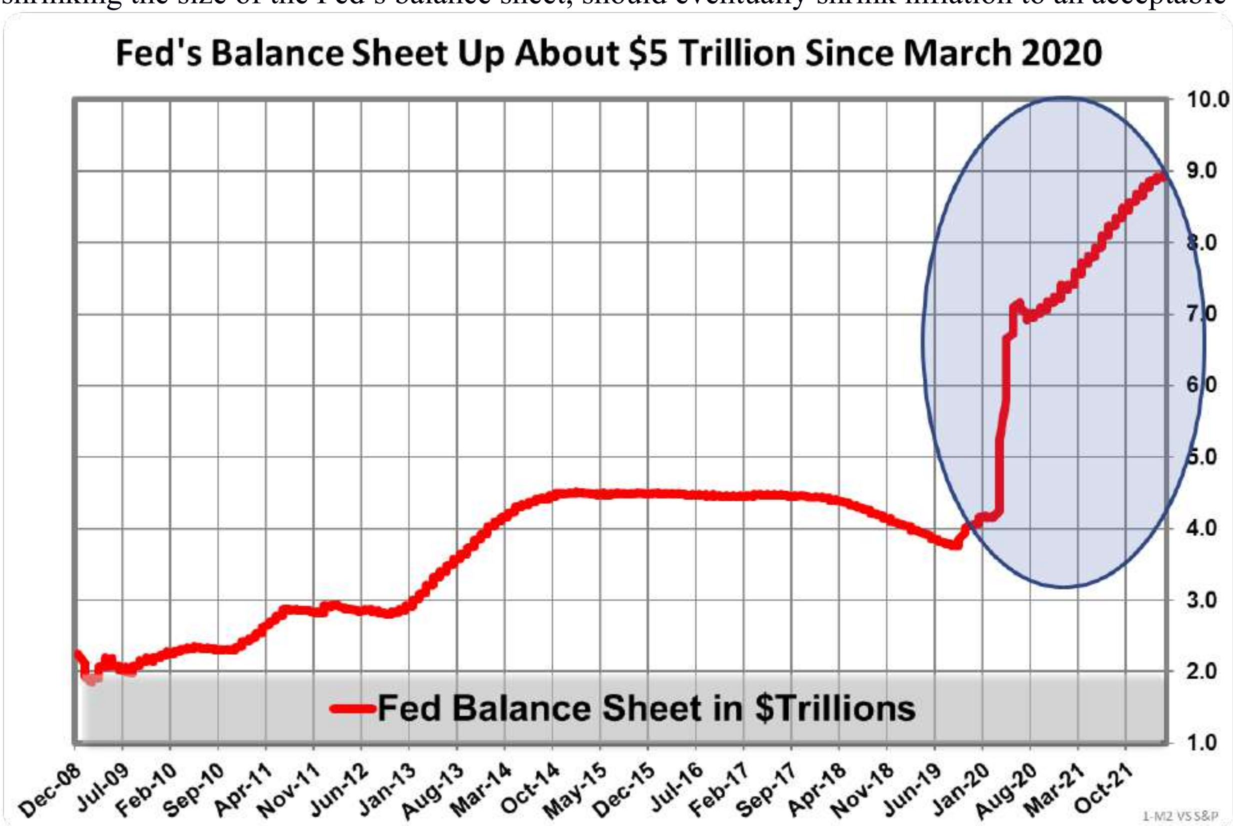
Leads to: Upward Wage Pressure. Average Hourly Wages up 5.7% → **Environment Very Positive for Risk Assets, Stocks and Real Estate** → **Now: Essentially Full Employment and Inflation Everywhere** → **Fed's Job is to: Whip Inflation Now, Without Causing a Recession**

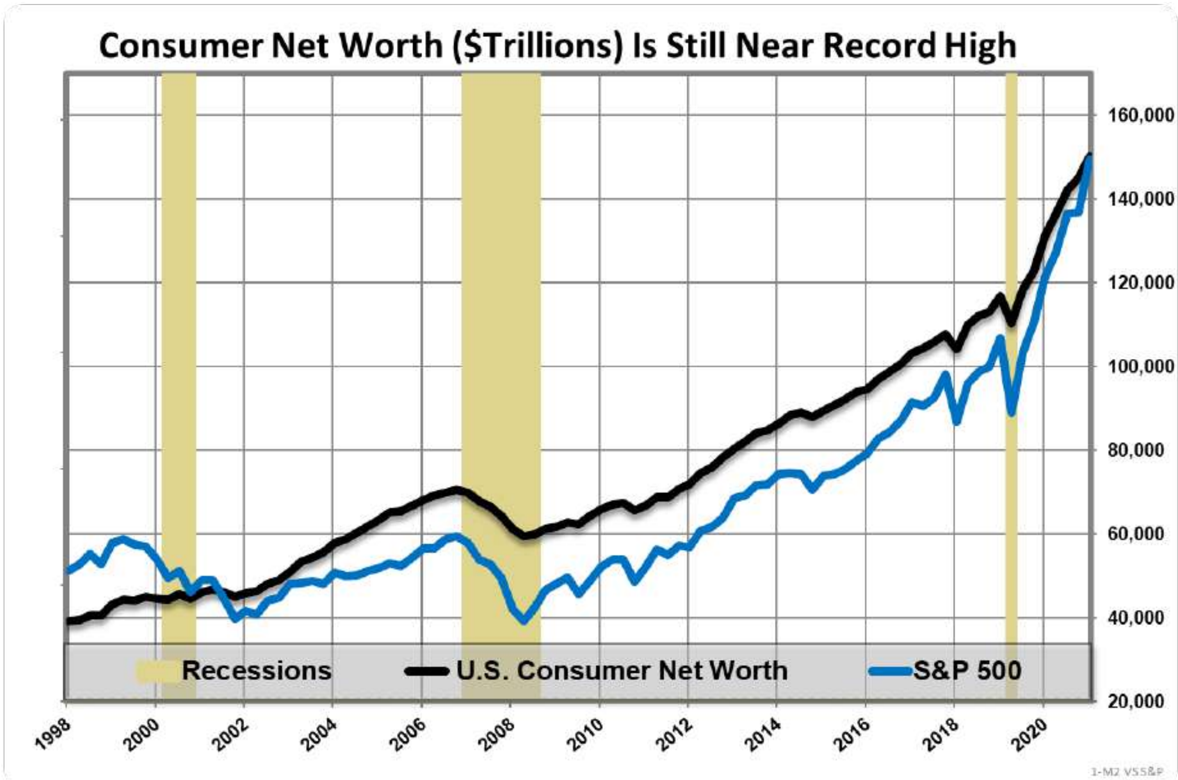
Federal Reserve Raises Rates and Shrinks Its Balance Sheet → **Economy Slows Down, Reduced Demand for Commodities** → **Stable or Declining Raw Material Costs- Downward Pressure on PPI** → **Supply Chain Problems Correct**

Stable Consumer Prices- Downward Pressure on CPI → **Less Wage Pressure and Inflation Comes Under Control** → **Finally, Central Banks Cut Rates to Prevent a Recession** → **Hopefully a Soft Landing for Economies Worldwide**

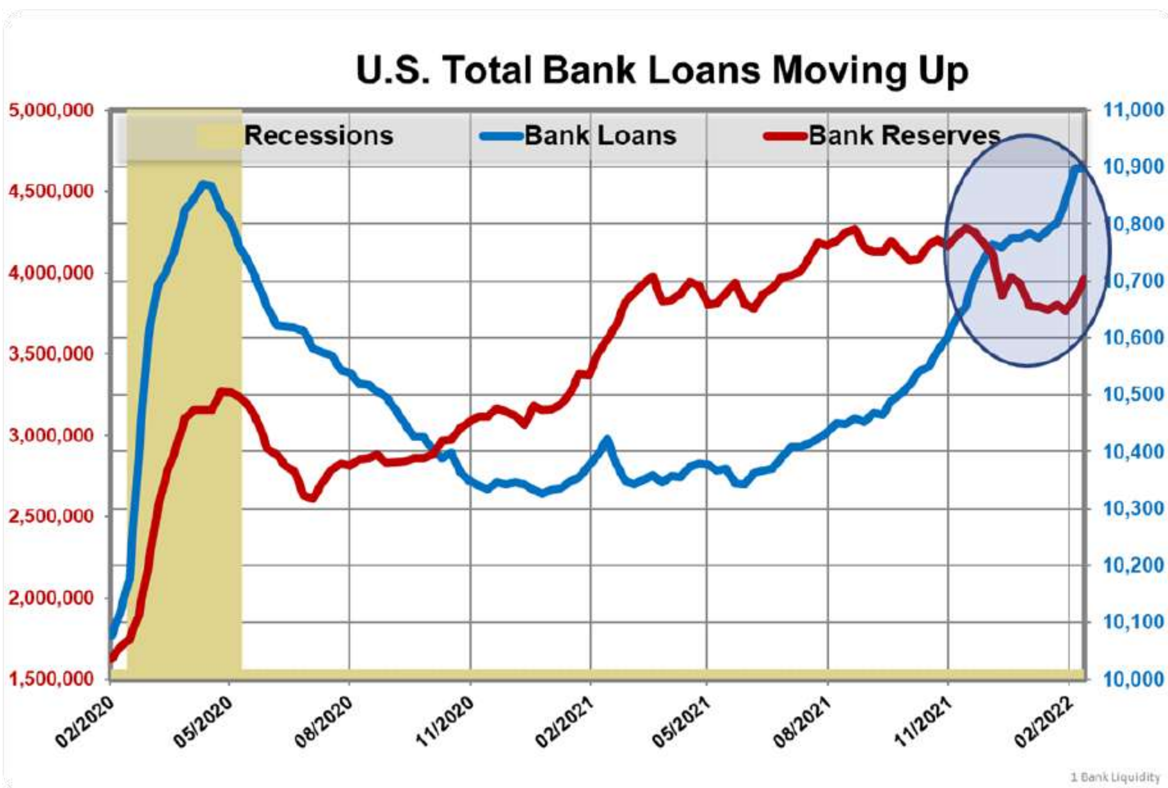


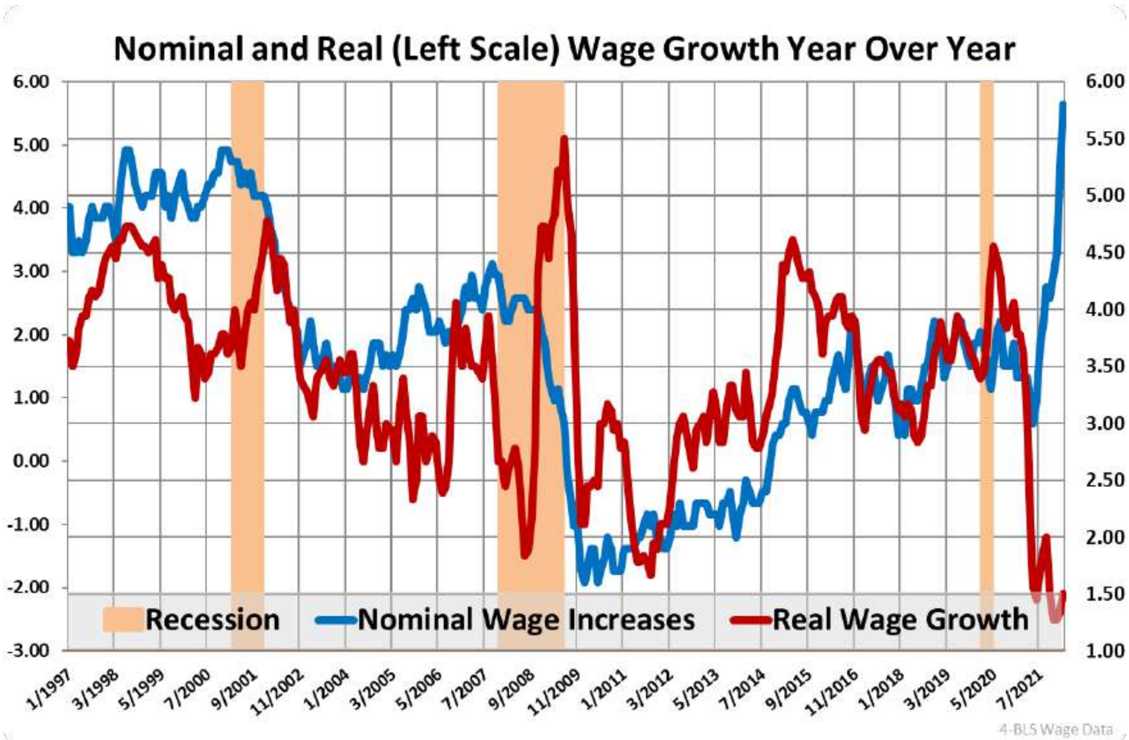
There is a correlation between the $5 trillion growth of the Federal Reserve's balance sheet (see below) and inflation levels (see above) that we have not seen since the 1970's. Raising interest rates and shrinking the size of the Fed's balance sheet, should eventually shrink inflation to an acceptable level.



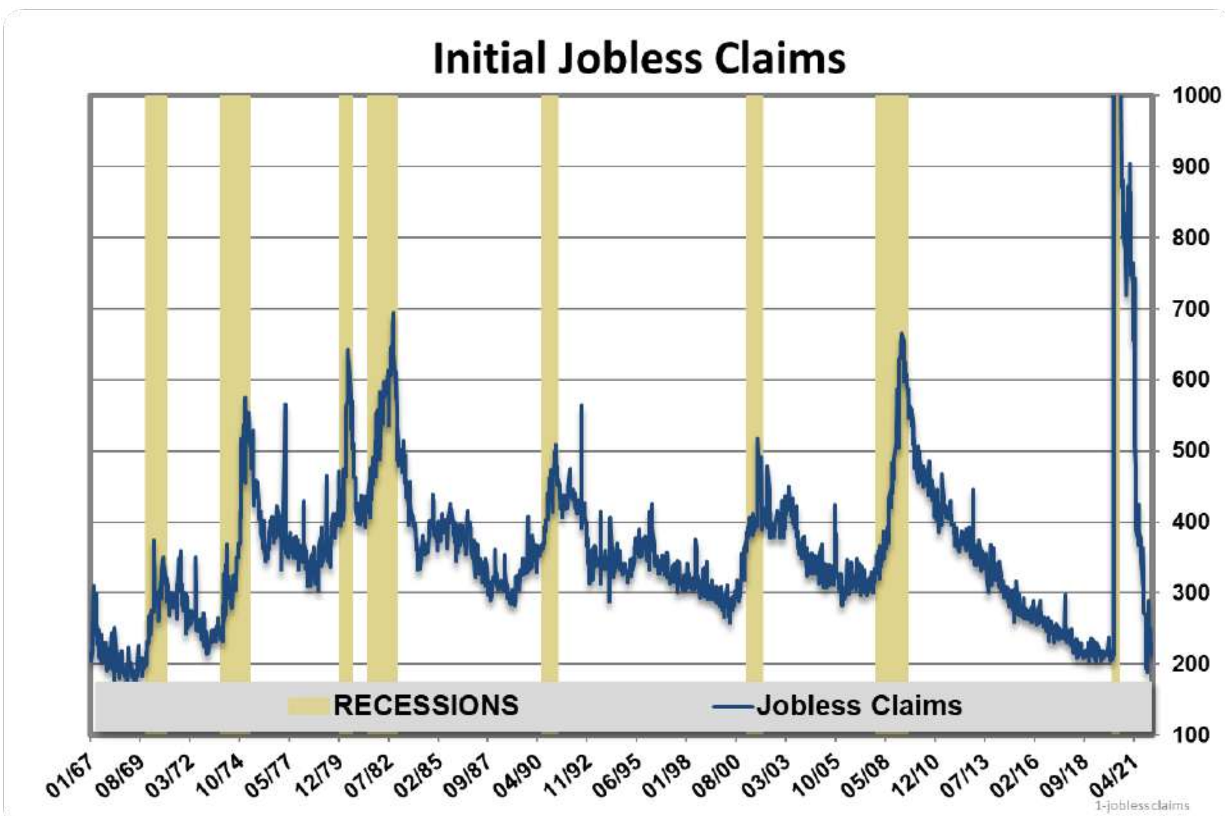


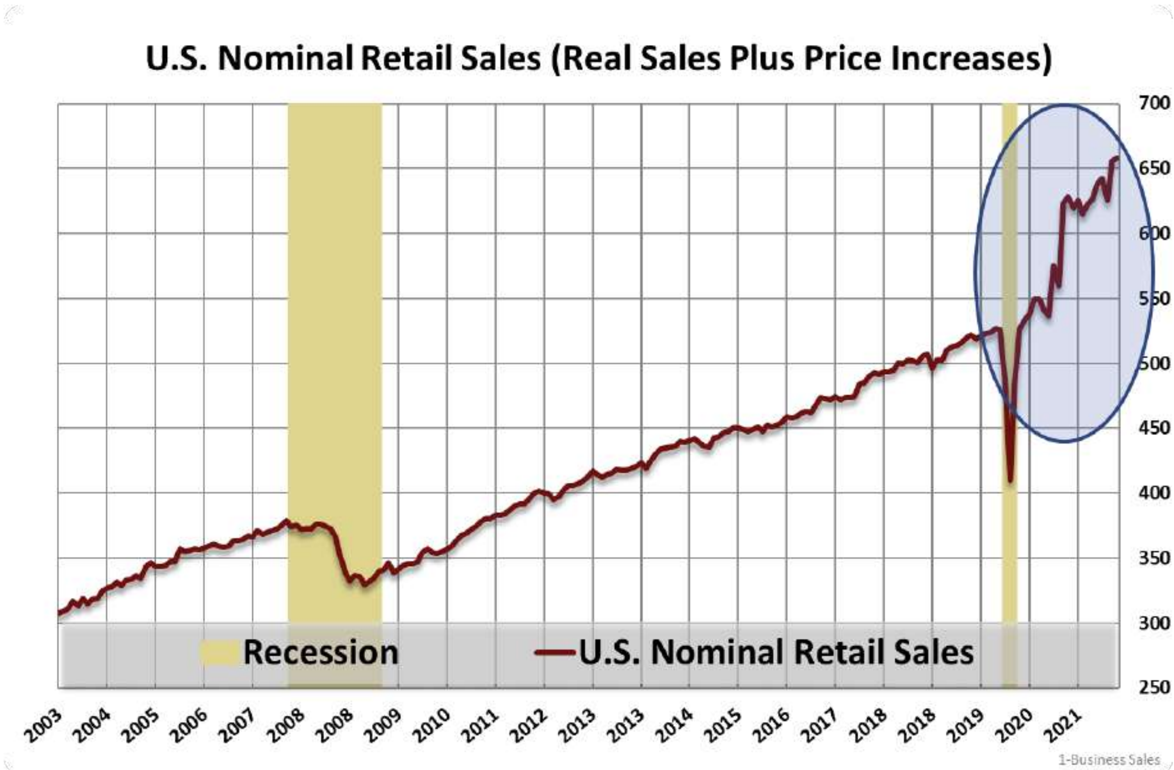
Historically high consumer net worth (see above), which leads to aggressive consumer spending, plus more money pumped into our economy from bank loan growth (see below), have contributed to today's high inflation. Quantitative tightening will slow or stabilize the price of risk assets such as stocks and real estate, reducing consumer net worth and putting downward pressure on inflation.



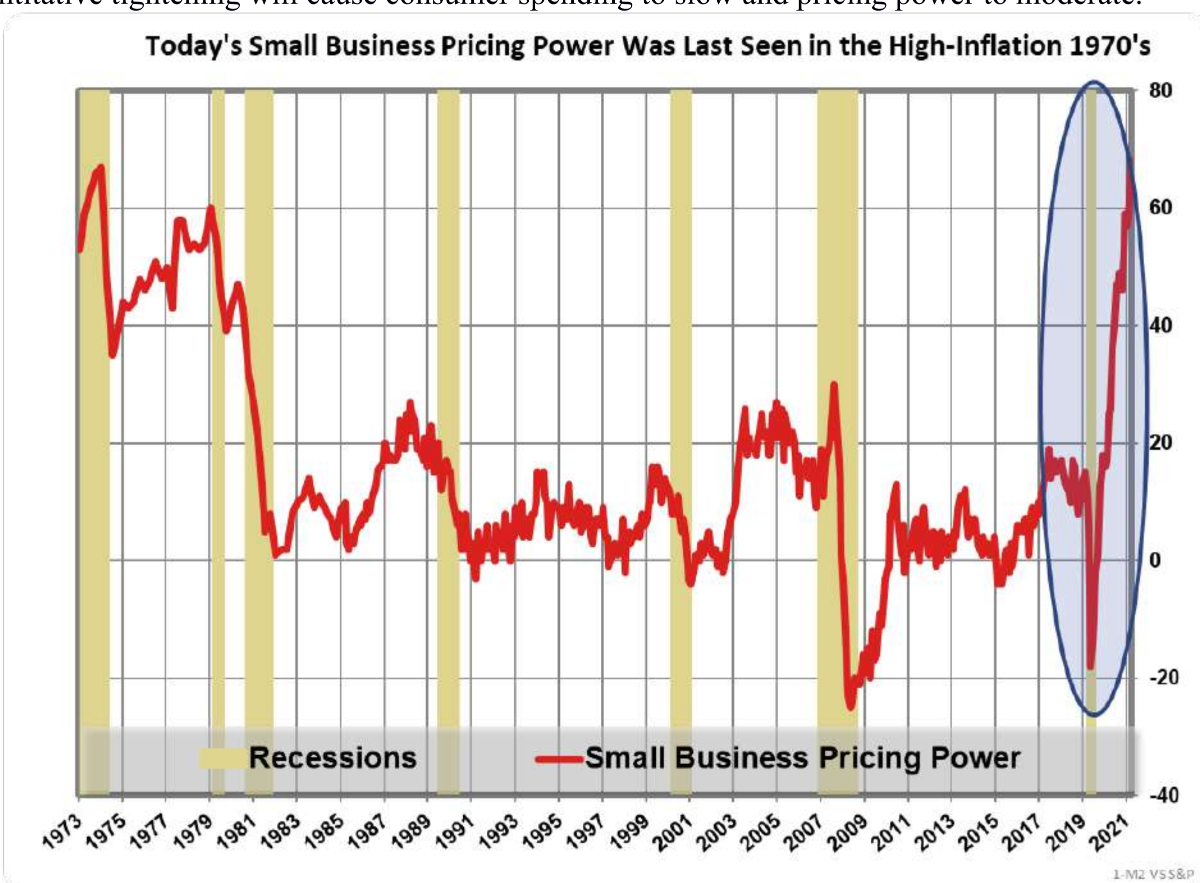


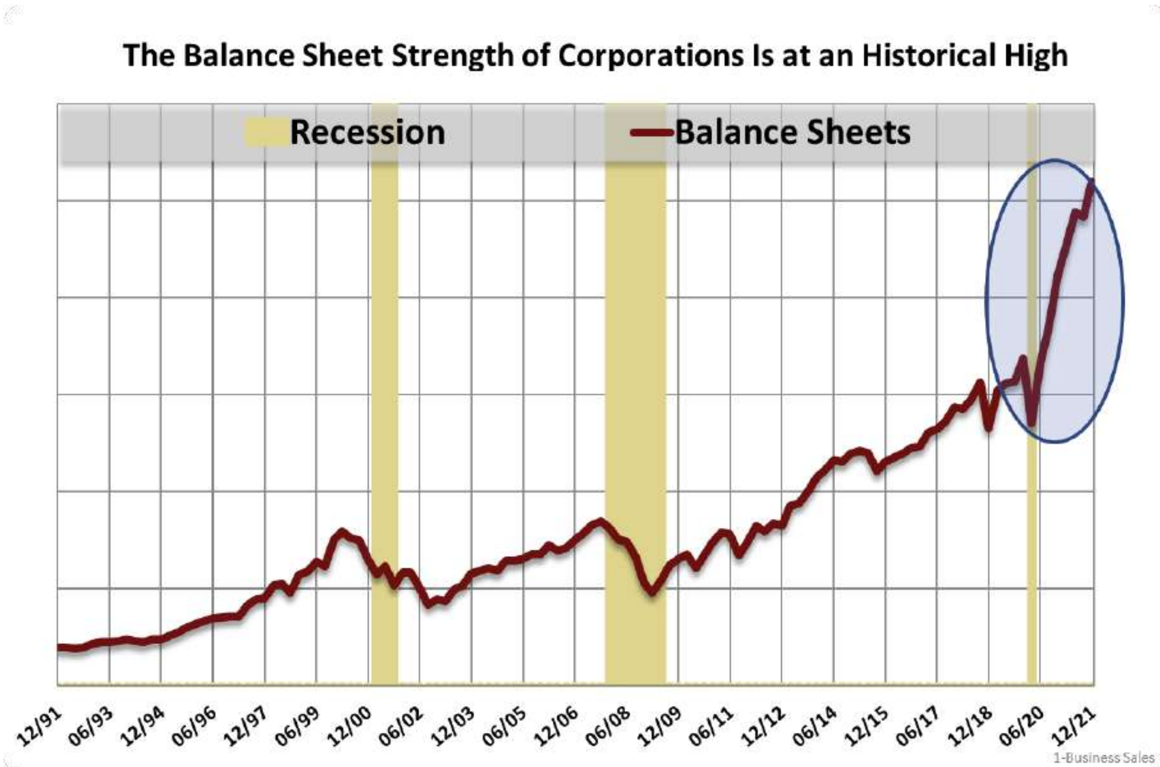
The spread between real (after inflation) and nominal wages is historically wide (see above) and we have near-full employment, with Jobless Claims at a 52-year low (see below). This is causing workers to demand more pay, exerting upward pressure on inflation. Fed tightening will reverse these trends.



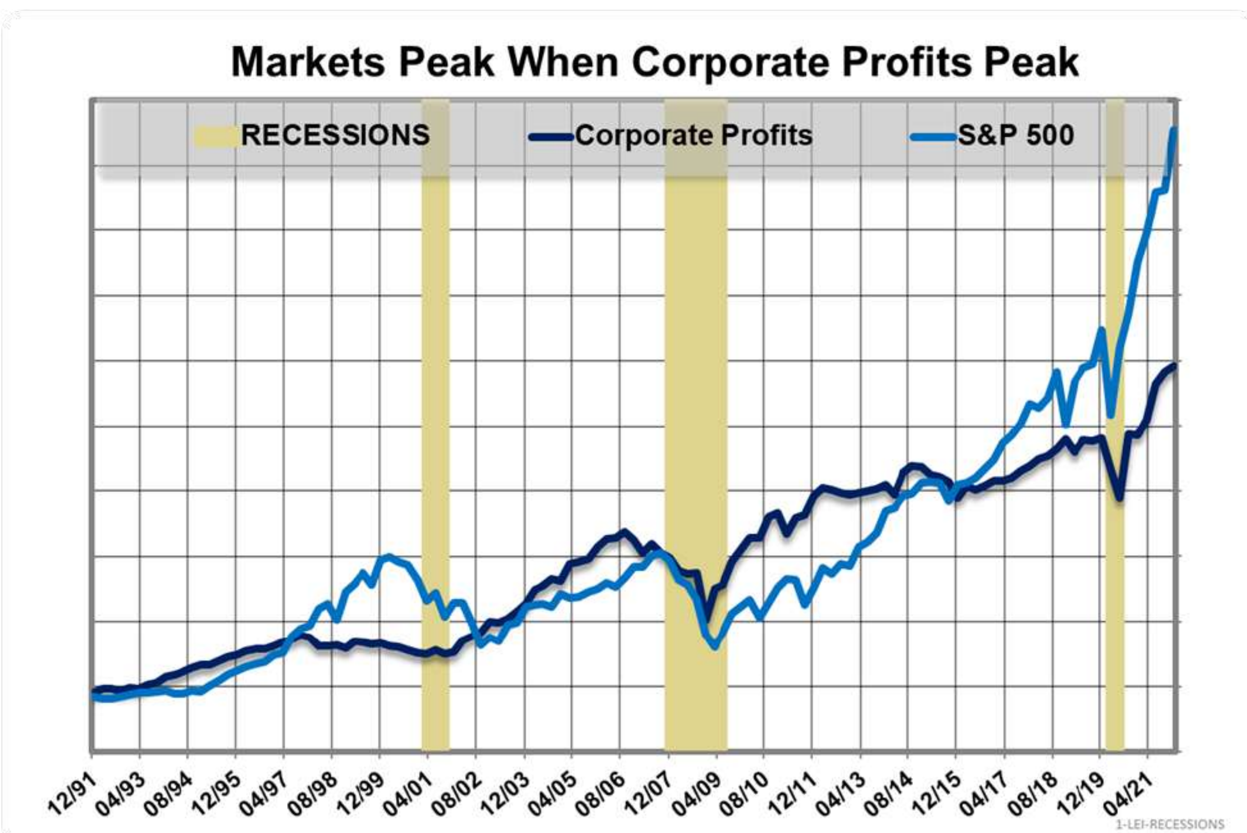


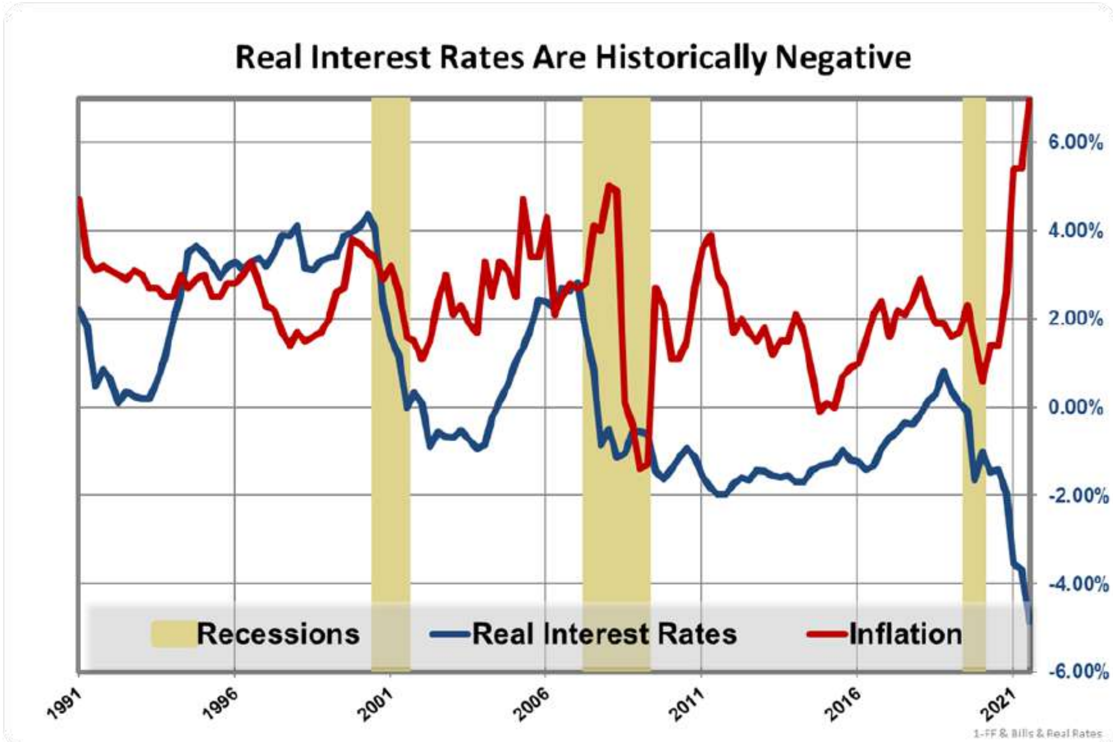
Nominal retail sales are soaring and businesses have strong pricing power, pushing inflation even higher. Quantitative tightening will cause consumer spending to slow and pricing power to moderate.



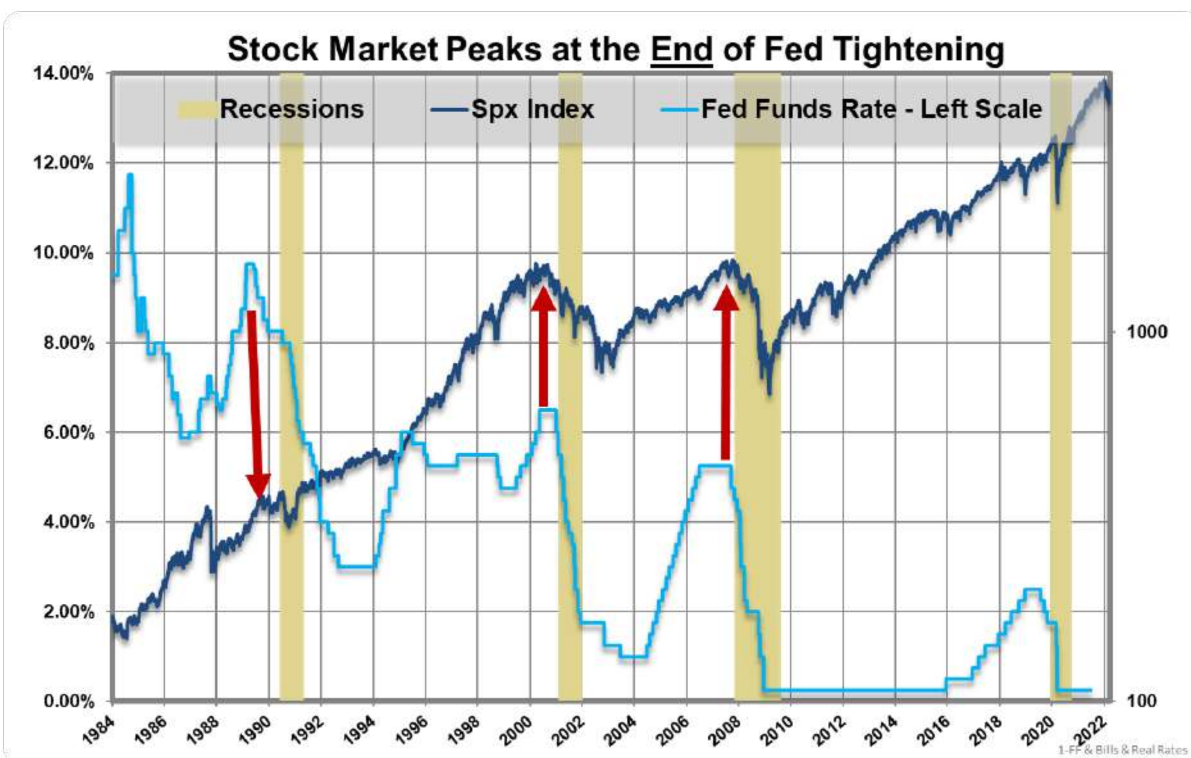


Corporations have taken advantage of historically low interest rates and a booming economy to strengthen their balance sheets (see above), which augurs well for future profits. Markets peak when corporate profits peak (see below), which may take years.





Real Interest rates are at a historically negative level (see above). This has encouraged borrowing and discouraged savings, keeping upward pressure on risk assets and inflation. Raising the Fed Funds rate will eventually reverse this aberration and get inflation under control. History tells us this will take time, maybe years (see below). Meanwhile, the stock market can continue to produce attractive returns and historically does not peak until the Fed quits raising rates, probably a year or so from now (see below).



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	*2.90*	*2.90*	*2.90*	*2.90*	*2.90*
	CA Muni Taxable Equiv.	5.84	5.50	5.11	4.41	4.22
	Natl Muni Before-Tax	*2.90*	*2.90*	*2.90*	*2.90*	*2.90*
	Natl Muni After Calif Tax	2.51	2.54	2.57	2.60	2.63
1-3 years	CA Muni - Tax Free	*1.87*	*1.87*	*1.87*	*1.87*	*1.87*
3-5 Years to Maturity	Corp Bond Before-Tax	3.36	3.36	3.36	3.36	3.36
	Corp Bond After-Tax	*1.67*	*1.77*	*1.91*	*2.21*	*2.31*
5 Years to Call	Preferreds Before Tax	4.38	4.38	4.38	4.38	4.38
	Preferreds After-Tax	*2.18*	*2.31*	*2.48*	*2.88*	*3.01*
10 Year Maturity	Treasuries Before-Tax	2.37	2.37	2.37	2.37	2.37
	Treasuries After-Tax	*1.50*	*1.54*	*1.61*	*1.80*	*1.85*

Smart bond management is especially important in a rising interest rate environment. Bond yields are inching up, and quantitative tightening will push them even higher and their prices lower. Fixed income has historically been part of most portfolios, and carefully selected bonds still have a place, to preserve principal with a little return. Interest rates have generally declined for 40 years, allowing bonds to appreciate and to be a total return asset. Chances are this declining rate bull market has ended. Professional bond management is more vital than ever, and KCM's special expertise and experience investing in fixed income will help maximize your return and protect your principal.

There is a seismic reversal in Federal Reserve policy. The massive amount of stimulus Washington and the Federal Reserve have injected into the U.S. economy since the Covid pandemic began has created a very robust U.S. economy, with unprecedented distortions, illustrated on the preceding pages. *All* these distortions will be reversed as the Fed's focus now turns to fighting inflation by embarking on quantitative tightening, eliminating asset purchases, raising short-term interest rates, and reducing the size of its balance sheet.

***The big picture remains positive for owning risk asset*s.** Fed Chairman Jay Powell pointed out that monetary policy "works with a lag." Milton Friedman observed that "monetary actions affect economic conditions only after a lag that is both long and variable." It has been two years since quantitative easing started and, largely as a result, the economy is booming. Quantitative tightening will take time to affect the economy and the markets, likely a year or more. We encourage investors to continue to hold sensible risk assets like KCM's Dividend BlueBloods, companies we identify as smart long-term investments that make up a portfolio characterized by a healthy balance between growth and value. We still see tailwinds for the stock market in 2022.

Be assured that all of us at KCM are committed to your financial well-being. Our aim, always, is to help you make the wisest possible investment decisions. We thank you for your business and your trust.

Jay Kellett, Founder and CEO, and your KCM Team