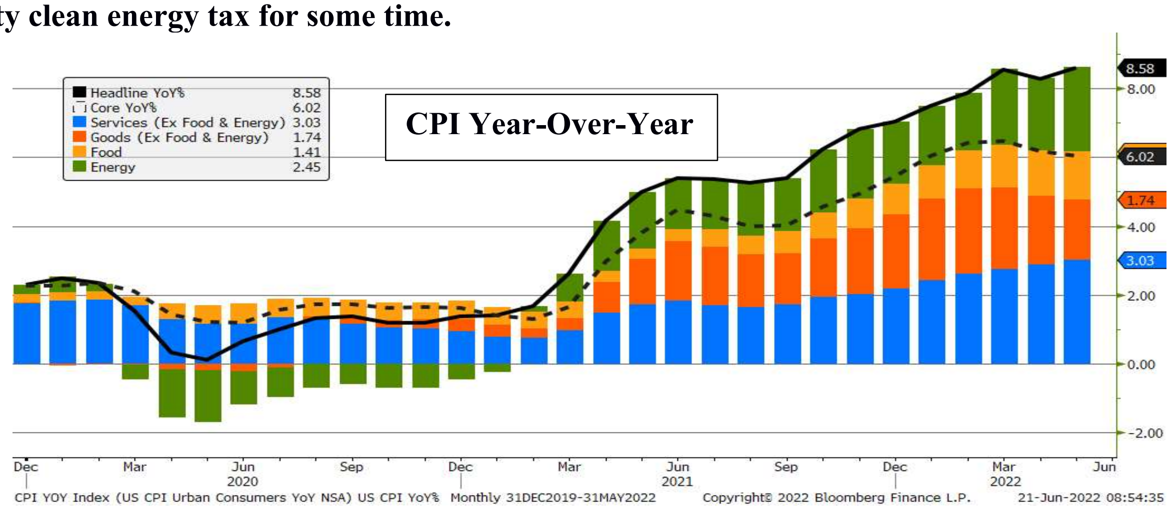
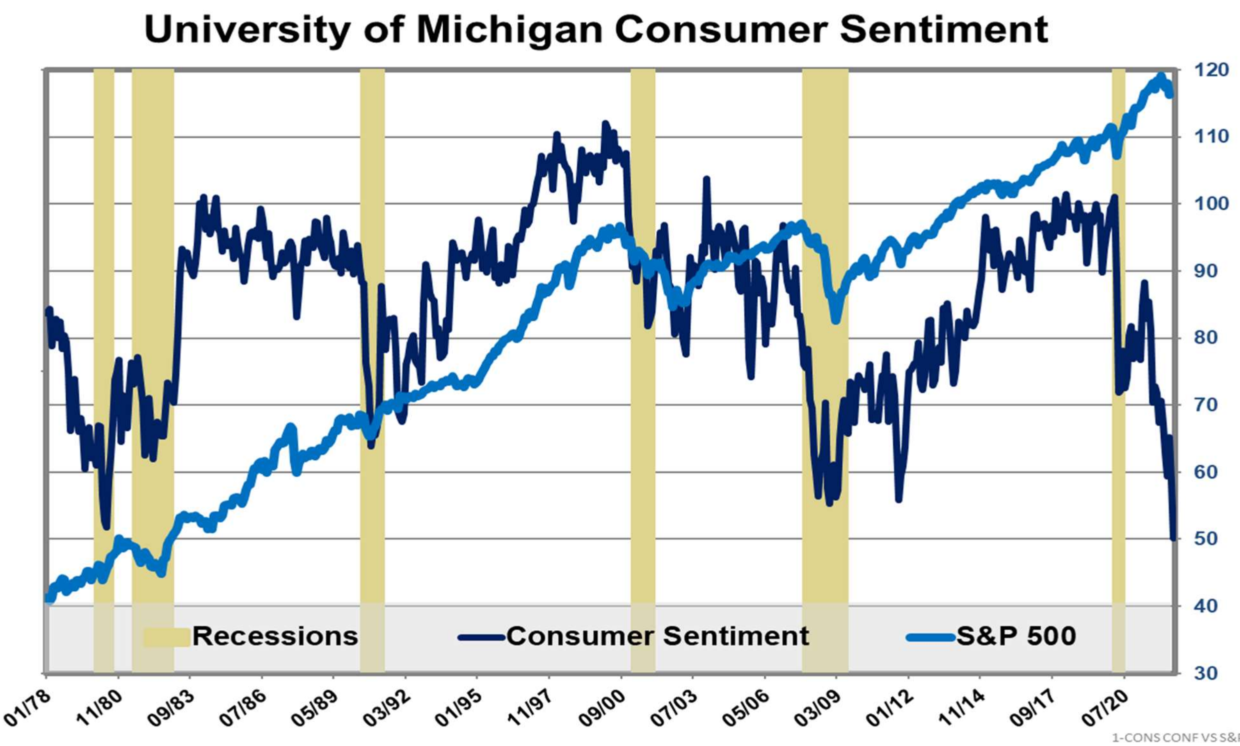
Public Enemy Number One

Unpleasant surprises in the inflation rate continue, and inflation is clearly "public enemy number one." The current economic cycle started in spring 2020, when the Federal Reserve and Washington injected an unprecedented dose of liquidity. While this bailed the nation out of the fastest and sharpest recession in history, it overstimulated the economy. President Biden's Covid subsidies and American Rescue Plan pared the U.S. unemployment rate to 3.6%, generating more jobs than willing workers, placing upward, inflationary pressure on wages. The Fed's Mount Everest of cash created unsustainable asset bubbles in the stock, real estate, collectibles, and crypto markets. Meanwhile, China's Covid shutdowns continue to generate supply chain problems, and Russia's invasion of Ukraine put further upward pressure on oil, gasoline, natural gas, and food prices.

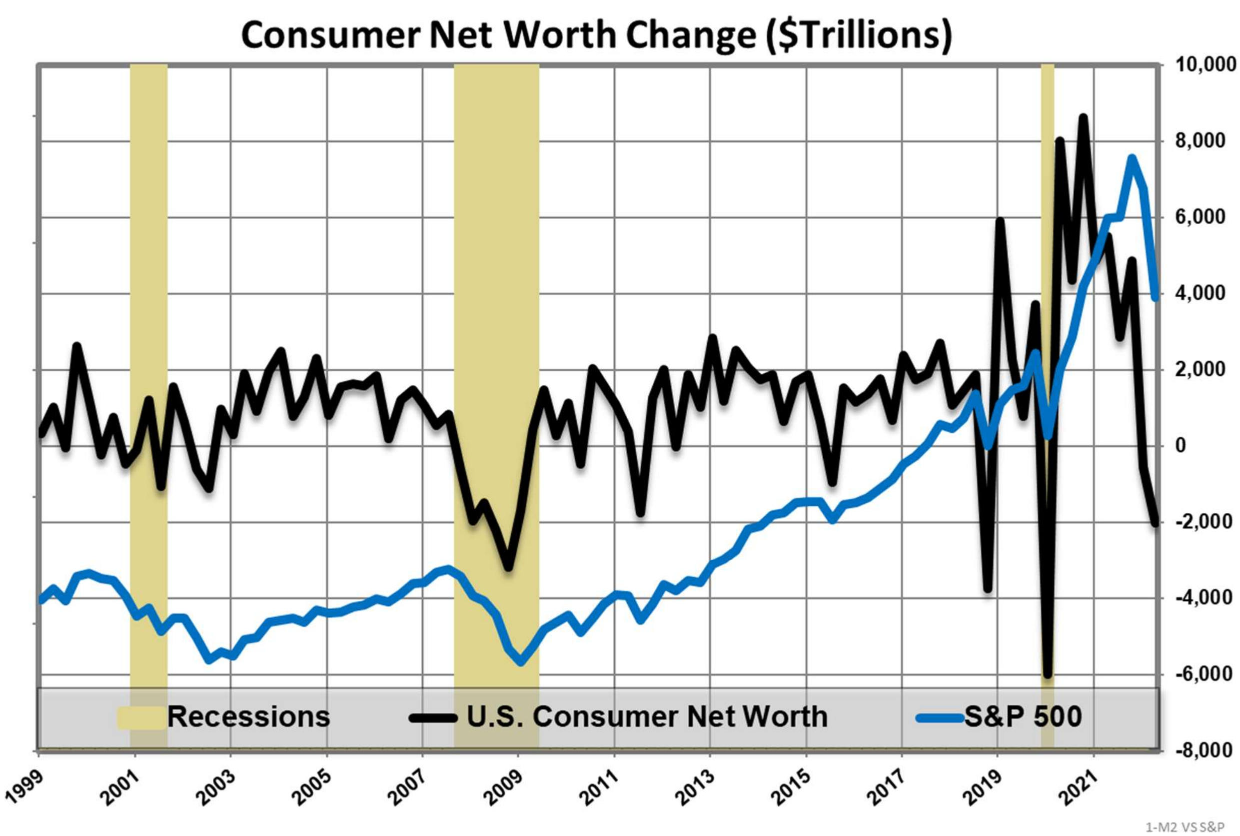
Obviously, too much money was pumped into our economy. The rampant inflation that ensued is forcing the Fed to slow the economy by focusing on stabilizing prices via quantitative tightening, curtailment of Treasury bond and Mortgage-Backed security purchases, and higher short-term interest rates. We are just a few months into this tightening cycle and economic growth has already stalled. In fact, we may already be in a shallow recession, defined as falling GDP in two consecutive quarters. Look at the evidence. First-quarter GDP dropped 1.4%, and the Atlanta Fed's GDPNow forecast is for flat second-quarter GDP. The University of Michigan Consumer Sentiment Index plunged from 58.4 in May to 50.2 in June, the lowest recorded level since the university started collecting data in 1952. Consumer Net Worth has declined sharply, and the stock market alone has lost over $12 trillion of value. The Money Supply growth rate has slowed dramatically. Some commodity prices have rolled over, lumber prices have plummeted 60%, and copper prices were down 13% this quarter, anticipating a housing slowdown as mortgage rates doubled. Oil prices are off about 10% from their recent high, but still up about 60% year-to-date. Gasoline sales have declined, and futures prices are off about $0.45 from their early-June high.

Since higher energy prices feed into higher food, goods, and services prices, we expect no real relief from inflation until energy prices decline. The Fed has little ability to accomplish this, and the current administration's energy policy still restricts production and pipelines. We will all be paying a hefty clean energy tax for some time.

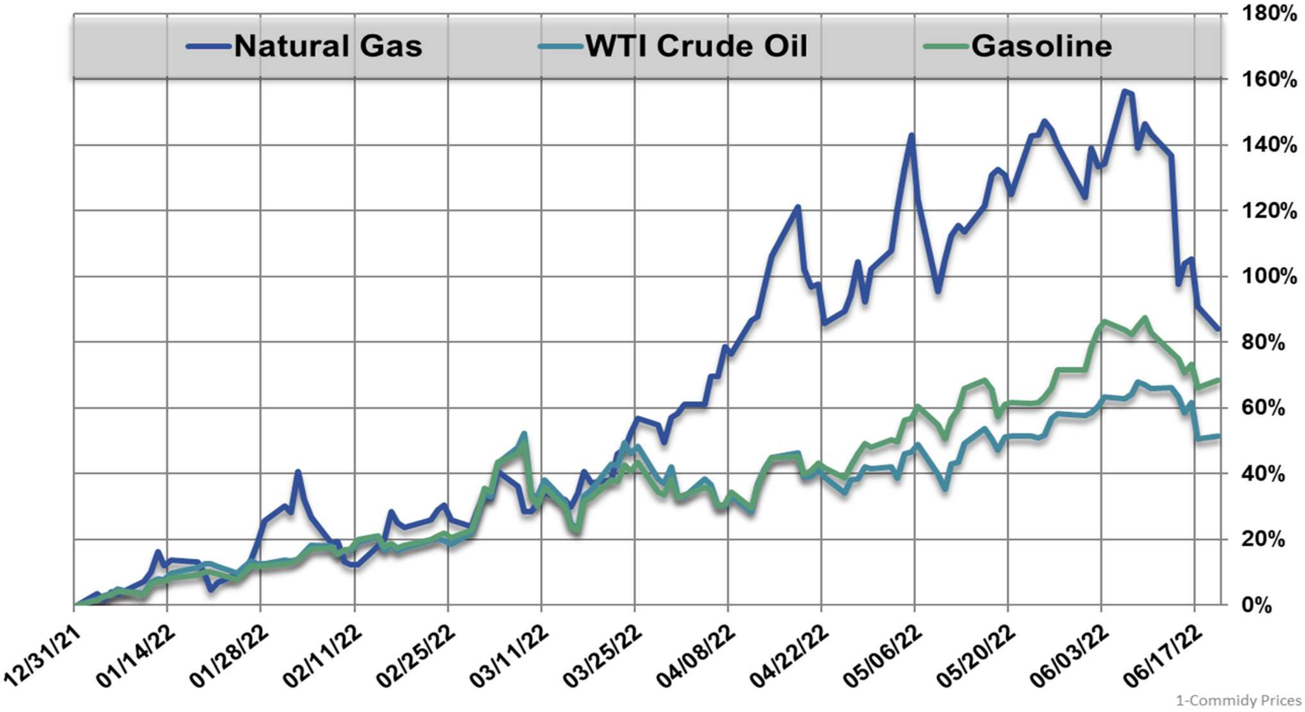




The decline in Consumer Sentiment (see above) is shocking, and at a level that is consistent with both a recession and past market bottoms. The dramatic change in Consumer Net Worth (see below) immediately alters spending habits, dampening inflation. It also portends a recession down the road.

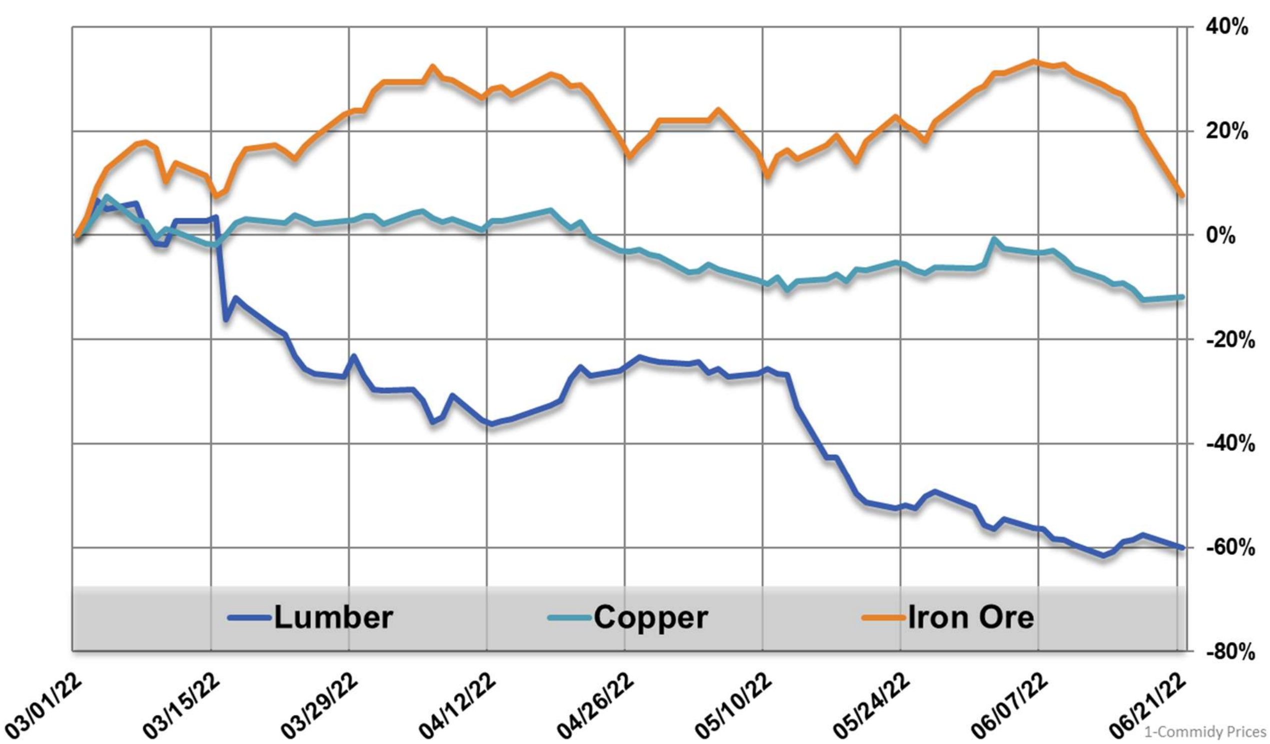


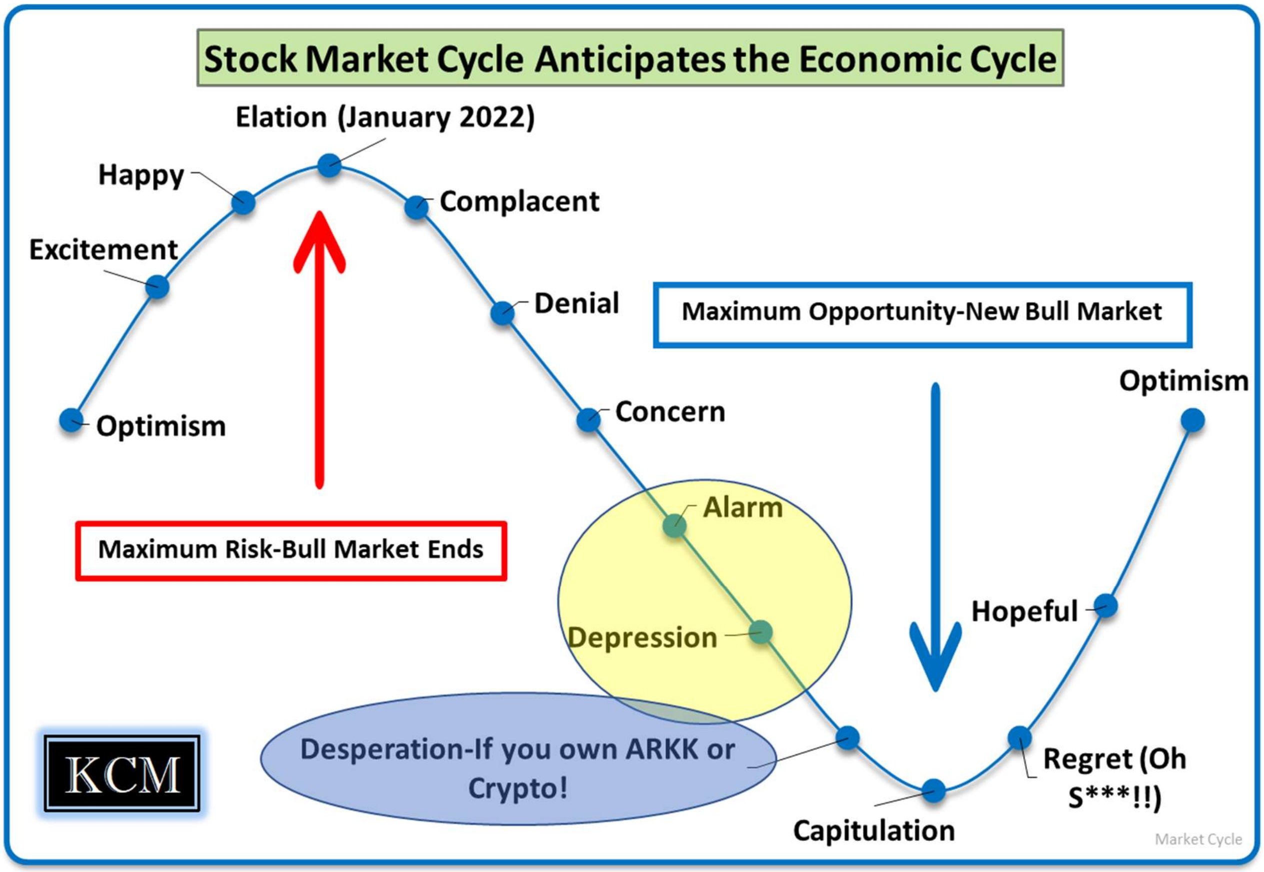
Key Energy Prices MAY Be Rolling Over, But are Still Up Sharply



One of the first signs that inflation may be peaking is commodity prices rolling over. The charts illustrate that some key, inflation causing, commodities like Natural Gas, Oil, Gasoline, Lumber, Copper, and Iron Ore may have peaked.

Other Commodity Prices That MAY be Rolling Over

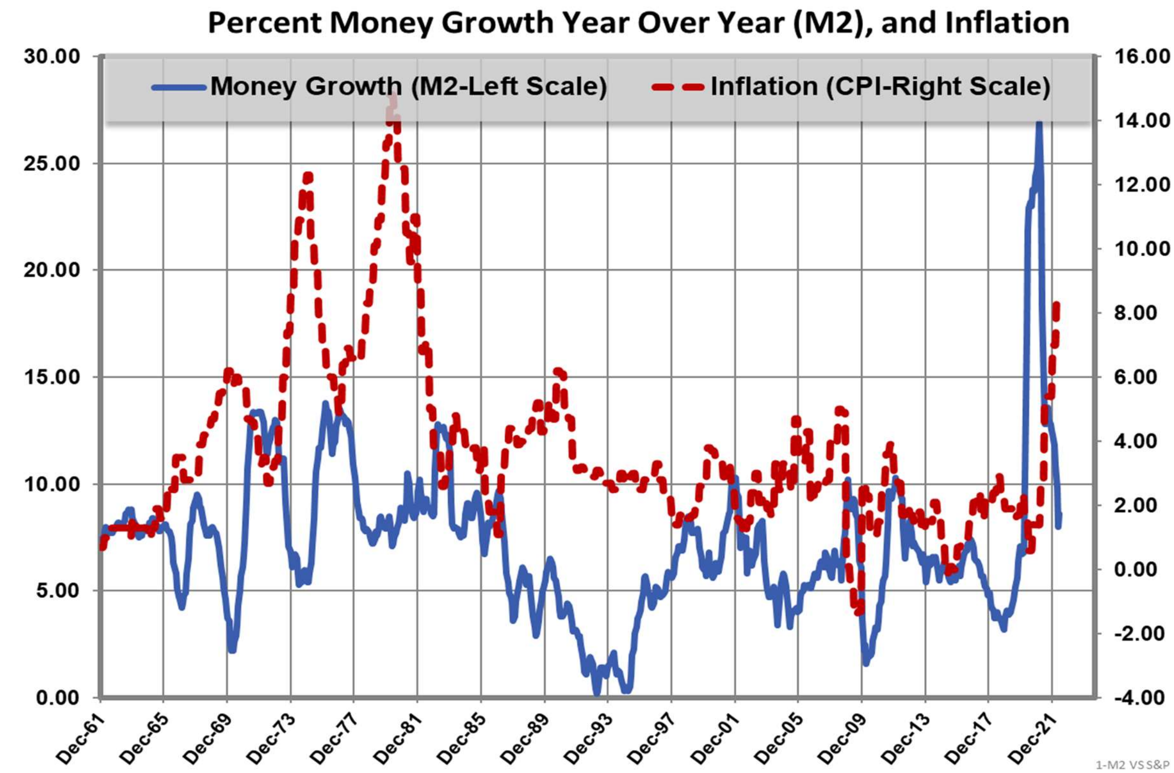




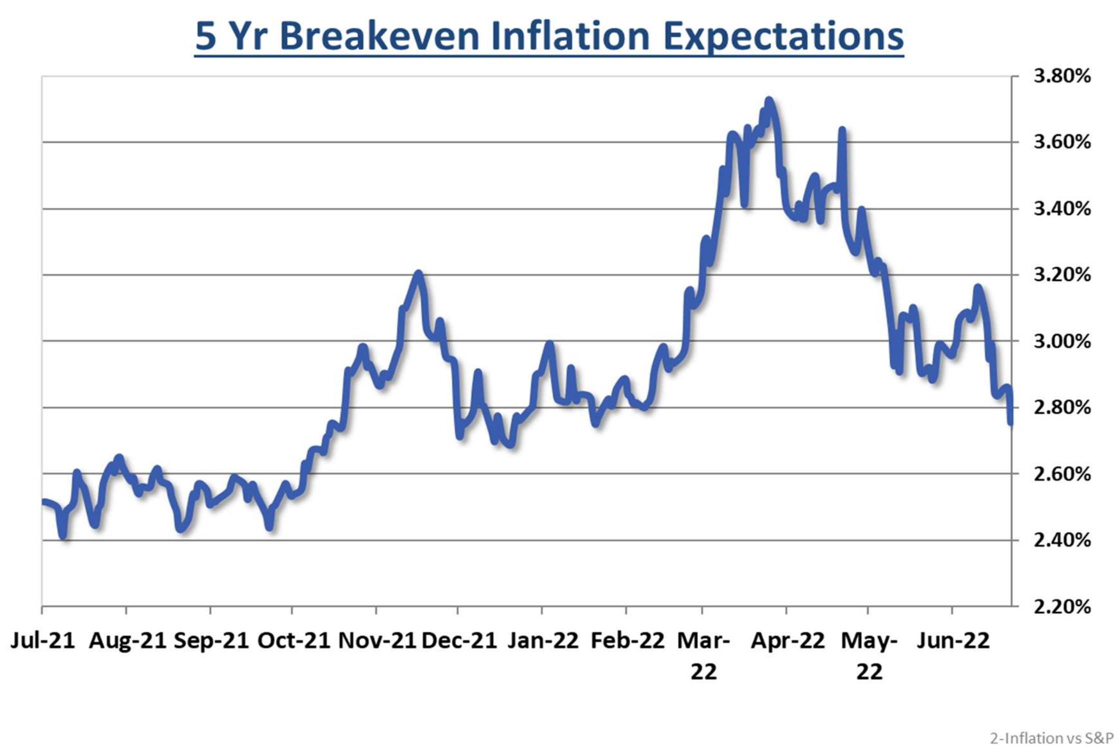
Declaring where markets will be in the future is a fool's game. There simply is no way to know. Nonetheless, as money managers, we must observe the environment, come up with the best predictions we can, and make investment decisions accordingly. The current Economic Cycle started in the spring of 2020. The Stock Market Cycle chart above reflects our view of where we are in that cycle.

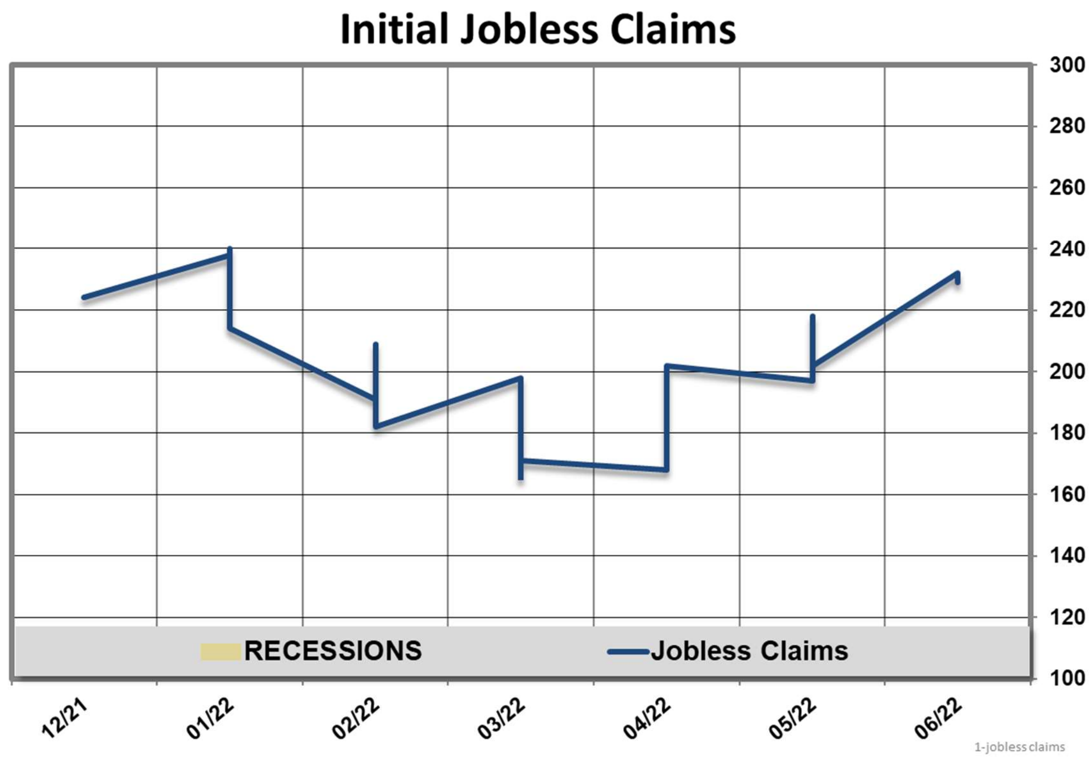
Unlike some of his predecessors, Fed Chairman Jay Powell tells us where Fed policy is heading. For instance, well before any action was taken, he announced that the Fed would be raising interest rates and reducing balance sheet purchases. As a result, much of the Fed's inflation-fighting work has already been done. For example, the economy is clearly slowing, GDP may show no gain this quarter, Money Supply growth has reverted to its historical range, the S&P 500 is off 21%, the Nasdaq is off 33%, Consumer Net Worth has plunged, some commodity prices are rolling over, gasoline volume sales have declined, jobless claims are moving up, retail sales have plummeted, house prices have probably peaked, global bond rates have surged, junk bond spreads have widened, and five-year inflation expectations have fallen. Bitcoin and Cathie Wood's ARKK fund have declined about 70%. **All this with the Fed Funds rate at only 1.60%!**

Many market pundits believe the Fed is "behind the curve," the Fed Funds rate should be much higher. Maybe so. But the stock market observes what has actually happened over the last six months and believes in Powell's resolve to "do what it takes" to bring inflation back down. Thus, we believe the stock market has mostly discounted future rate hikes and balance sheet adjustments, putting us close to the bottom of the stock market cycle.

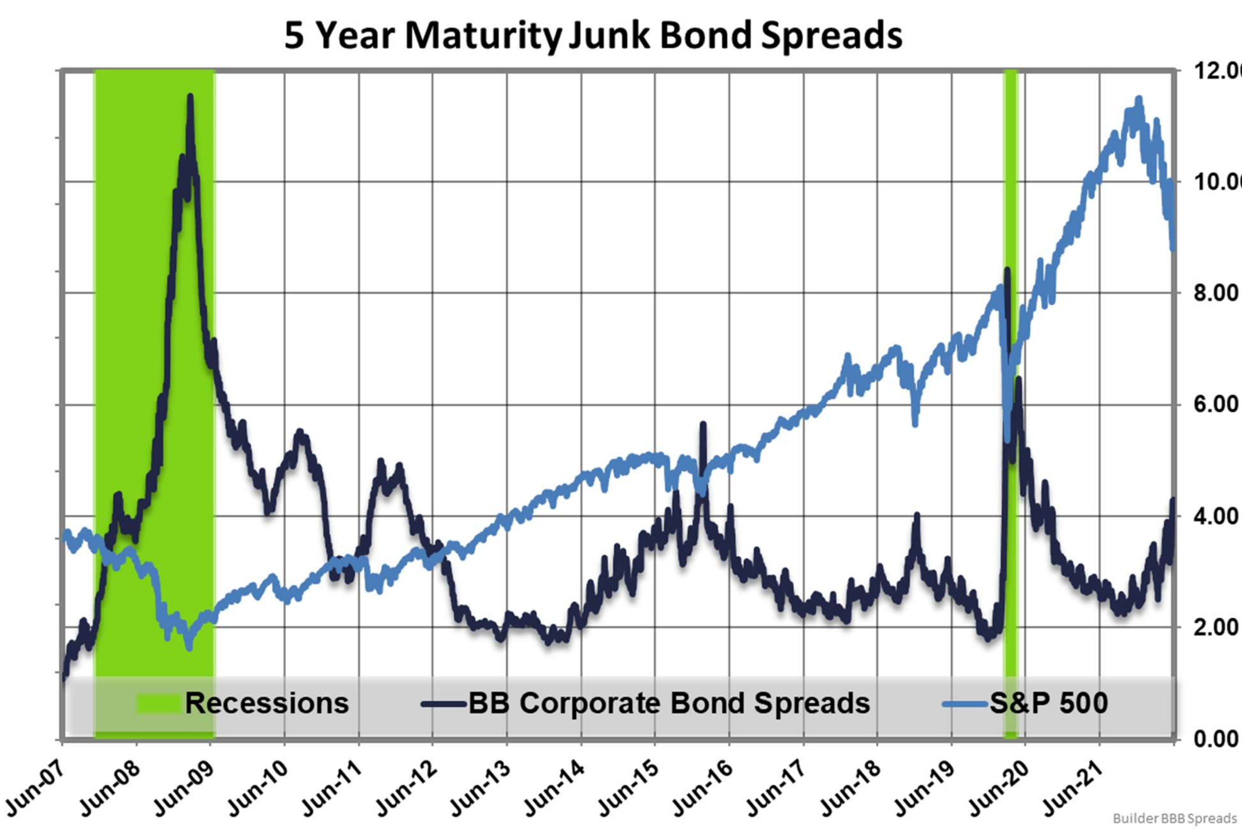


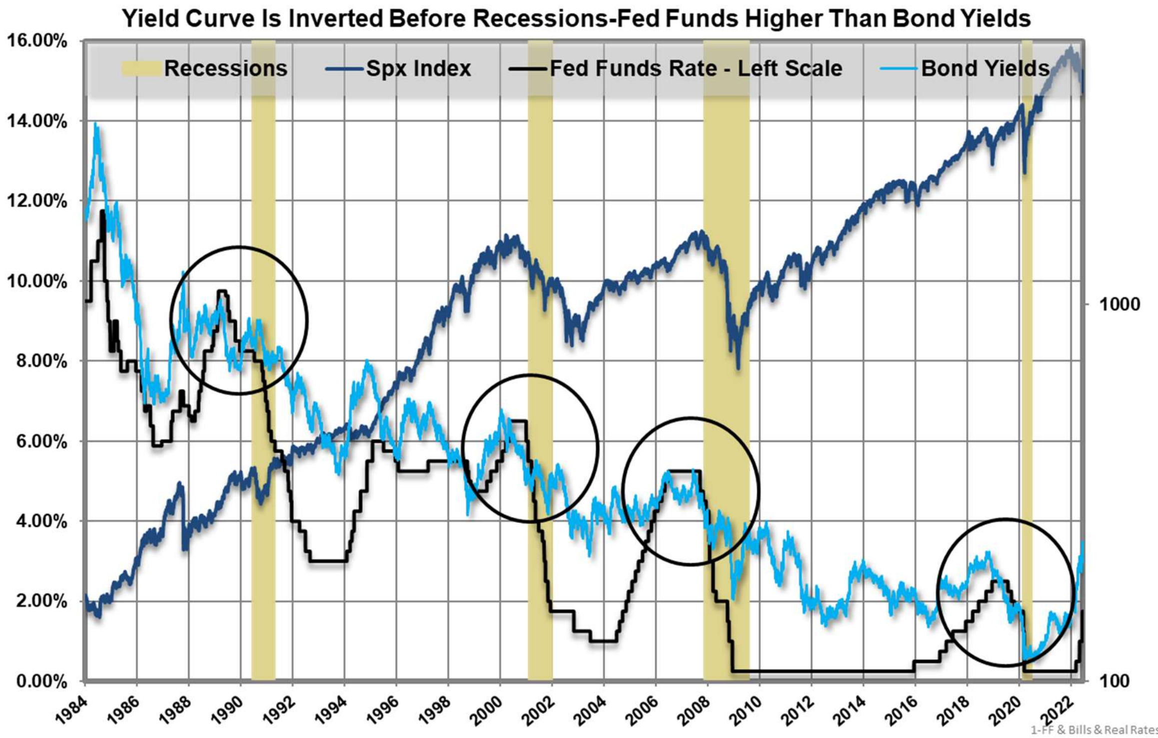
Milton Friedman said, “Inflation is always and everywhere a monetary (M2) phenomenon.” The historical correlation between M2 growth and inflation is not perfect but probably played a significant role in creating our current inflation (see above). Likewise, the recent sharp decline in M2 growth should have a dampening effect on inflation. Over the last few months inflation expectations have declined (see below) and the Fed Funds futures rate has also declined by about 40 basis points.



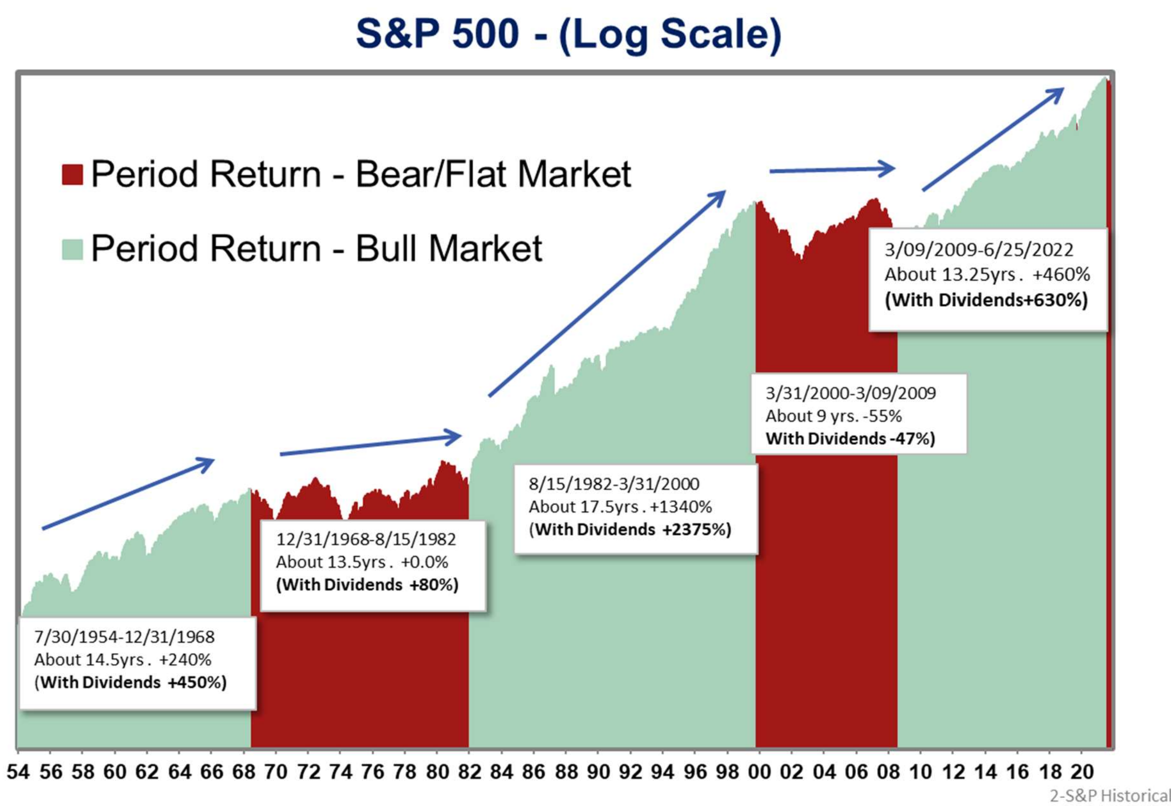


Initial jobless claims have hooked up (see above), an early sign of an inflation-diminishing economic slowdown. Junk bond spreads are widening (see below). Investors are recognizing the risk of a recession and are demanding higher yields.





Are we about to have a recession? The yield curve has always inverted a year or so before a recession. The Fed Funds yield has always been higher than the ten-year Treasury yield (see above). Today Fed Funds are 1.60% and the ten-year Treasury yields 3.10% -- still a very positive yield curve. Let us hope history is a good guide. See below for some historical market perspective.



KCM	Before & After-Tax Yields					
Call or Maturity	Calif. + Fed. Tax Brackets	54.0%	50.0%	45.0%	40.0%	35.0%
	Federal Tax Brackets	37%	35%	32%	24%	22%
8-10 Years to Call	CA Muni - Tax Free	*3.85*	*3.85*	*3.85*	*3.85*	*3.85*
	CA Muni Taxable Equiv.	8.37	7.70	7.00	6.42	5.92
	Natl Muni Before-Tax	*3.80*	*3.80*	*3.80*	*3.80*	*3.80*
	Natl Muni After Calif Tax	3.15	3.23	3.31	3.19	3.31
3 years	CA Muni - Tax Free	*2.50*	*2.50*	*2.50*	*2.50*	*2.50*
3-5 Years to Maturity	Corp Bond Before-Tax	4.20	4.20	4.20	4.20	4.20
	Corp Bond After-Tax	*1.93*	*2.10*	*2.31*	*2.52*	*2.73*
5 Years to Call	Preferreds Before Tax	5.23	5.23	5.23	5.23	5.23
	Preferreds After-Tax	*2.41*	*2.62*	*2.88*	*3.14*	*3.40*
10 Year Maturity	Treasuries Before-Tax	3.02	3.02	3.02	3.02	3.02
	Treasuries After-Tax	*1.90*	*1.96*	*2.05*	*2.30*	*2.36*

Smart bond management is especially important in a rising interest rate environment. Bond yields have inched up, and quantitative tightening may 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.

The initial stages of quantitative tightening have had an unexpectedly significant impact. The massive amount of stimulus Washington and the Federal Reserve injected into the U.S. economy since the Covid pandemic created a very robust U.S. economy, unsustainable asset bubbles, historically low unemployment, and historically high inflation. *All* these distortions show signs of being reversed as the Fed's focus has turned to fighting inflation by embarking on quantitative tightening, starting with raising the Fed Funds rate to just 1.60%.

The big picture remains positive for owning risk assets. Fed monetary policy "works with a lag," but the stock and bond markets observe whether that policy is working and anticipate where that policy will eventually lead. In our judgment, the stock and bond markets believe much of the Fed's inflation-fighting policy is starting to work, and this is mostly discounted in current prices. 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. There are signs inflation may be peaking, and that should be a tailwind for the stock market.

As Bette Davis warned in All About Eve, "Fasten your seat belts – it's going to be a bumpy ride." But at KCM, we are confident we have the savvy to guide you through the turbulence, just as we have successfully guided investors through past downturns. We are proud of our record, and you should 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

Note: All graphs were produced by KCM, with data from Bloomberg.