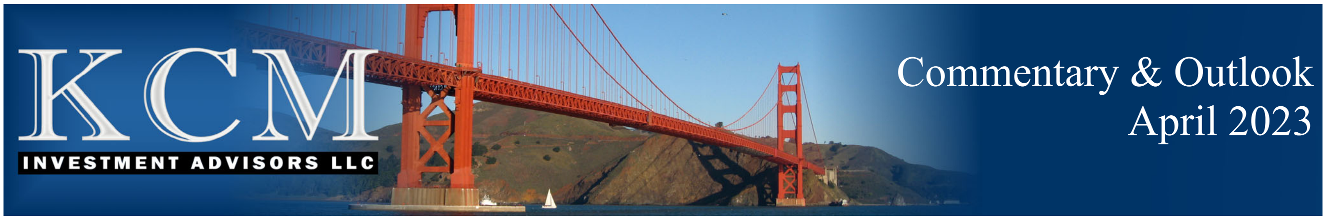
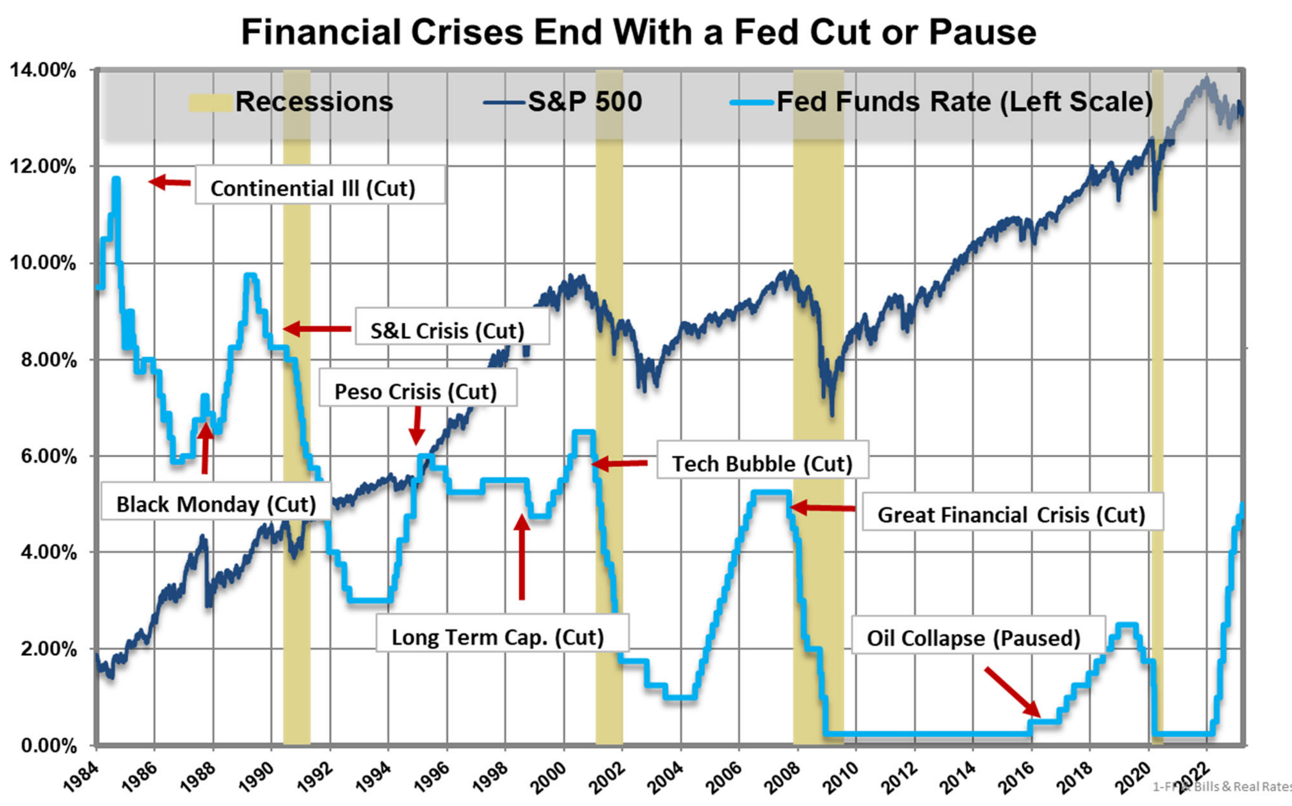


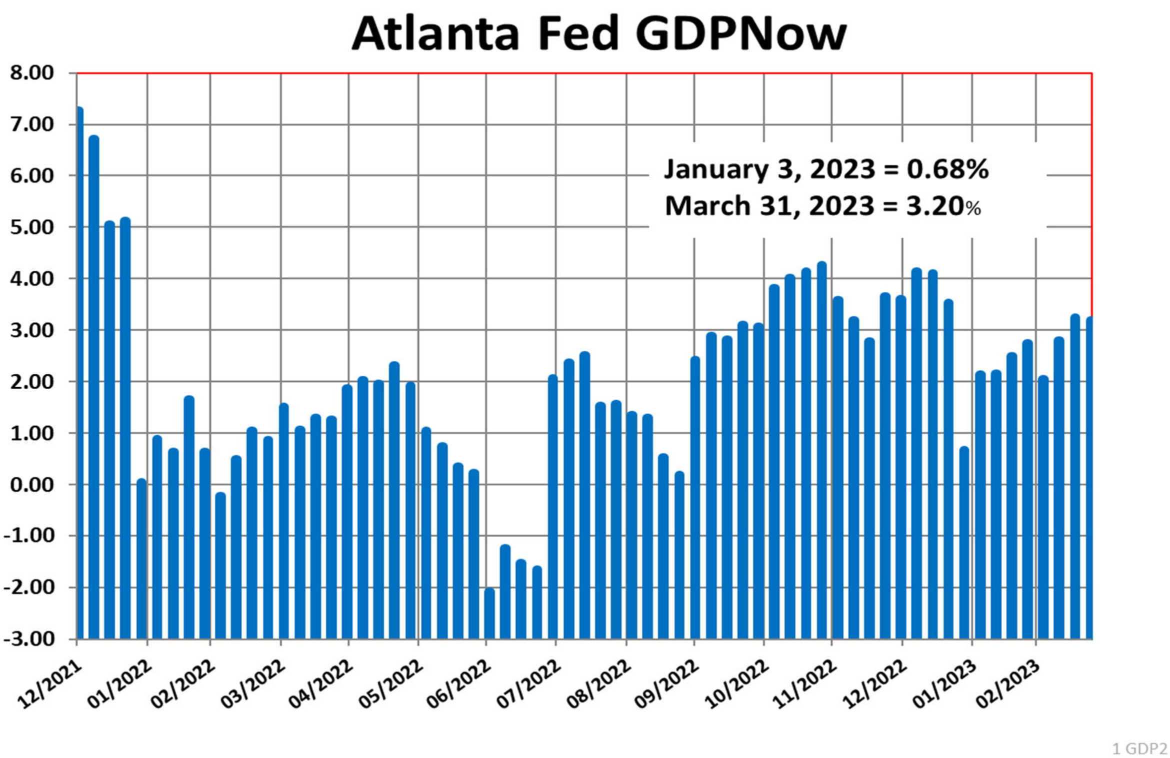
Every Fed Tightening Cycle Ends In a Crisis

Every Federal Reserve tightening cycle has created a financial crisis. The current deposit run on regional banks probably fits this cycle's financial crisis definition. Legendary economist Ed Hyman points out that after each of the financial crises since 1984, the Fed either eased or paused to try to control the situation (see chart below). Fed Chairman Jay Powell has noted, "History shows that isolated banking problems, if left unaddressed, can undermine confidence in healthy banks and threaten the ability of the banking system as a whole."

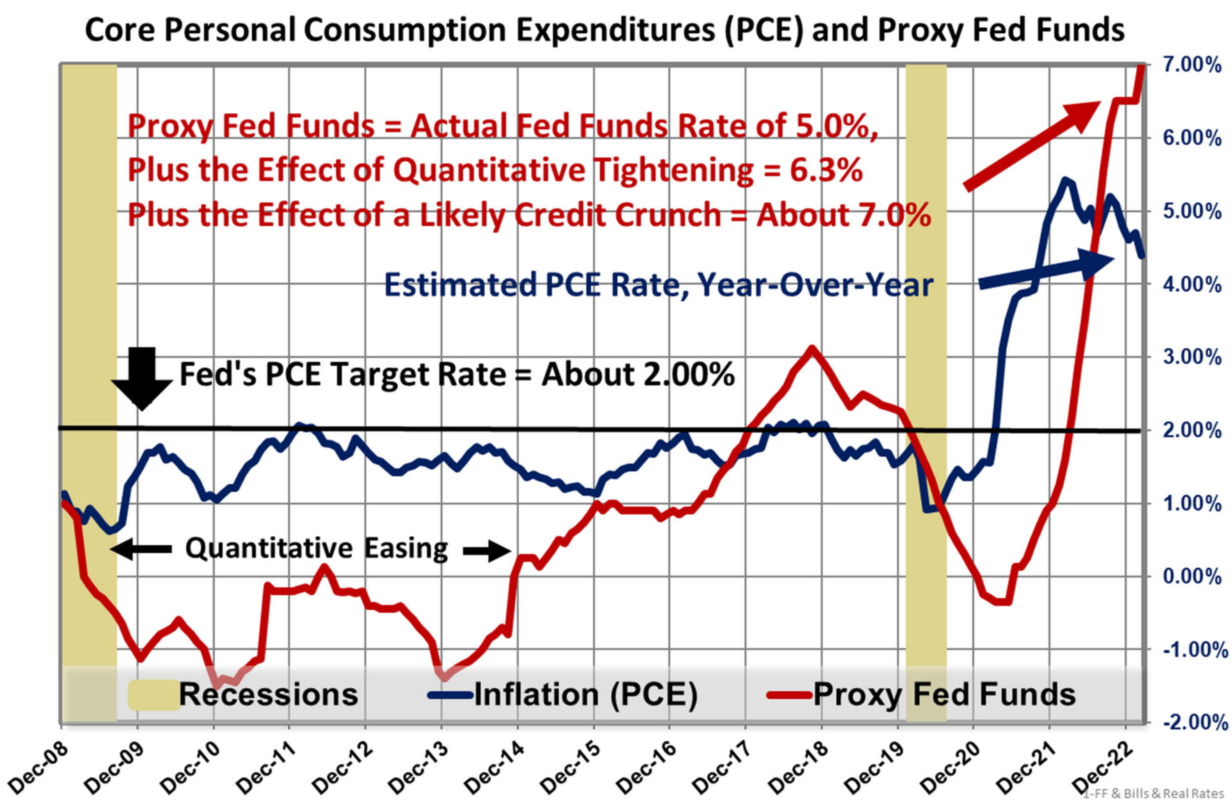
Nonetheless, on March 22, the Federal Reserve implemented an unprecedented rate hike despite many signs that the current crisis is not over, as well as history's lesson that crises don't end until the Fed at least pauses. The main reason for this hike seems to be that inflation is still not under control, as evidenced by the latest Consumer Price Index gain of 6% year over year. However, it should be noted that the CPI is backward-looking, and the forward path for inflation is clearly down, given that oil prices have plummeted, import prices for fuel and food are flat year over year, the Core PCE slowed to 0.3% month over month (3.6% annualized) and service worker wages and benefits, a key contributor to inflation, slowed dramatically in the Philadelphia Fed's latest survey. Commodity prices have also declined substantially.

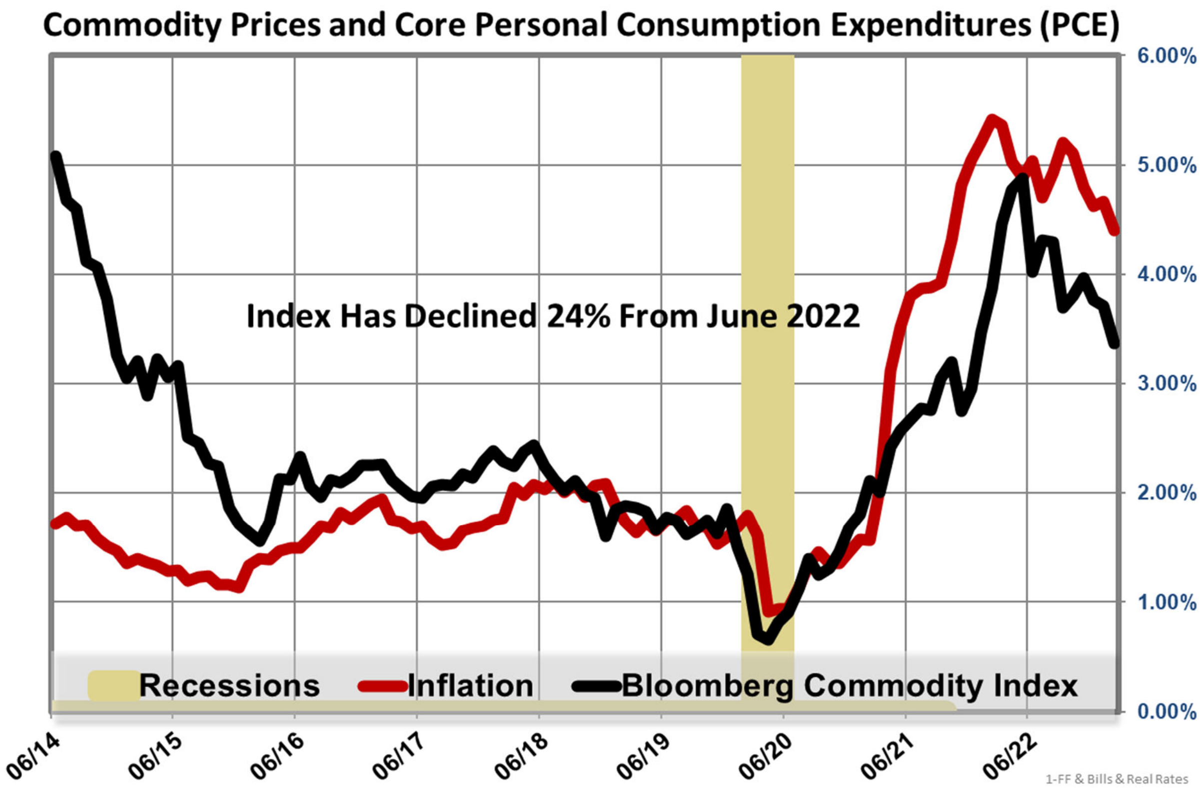
Even so, it seems that the Fed and other central banks around the world continue to tighten, boosting the risk that this banking crisis is not over, and other financial crises may be coming.



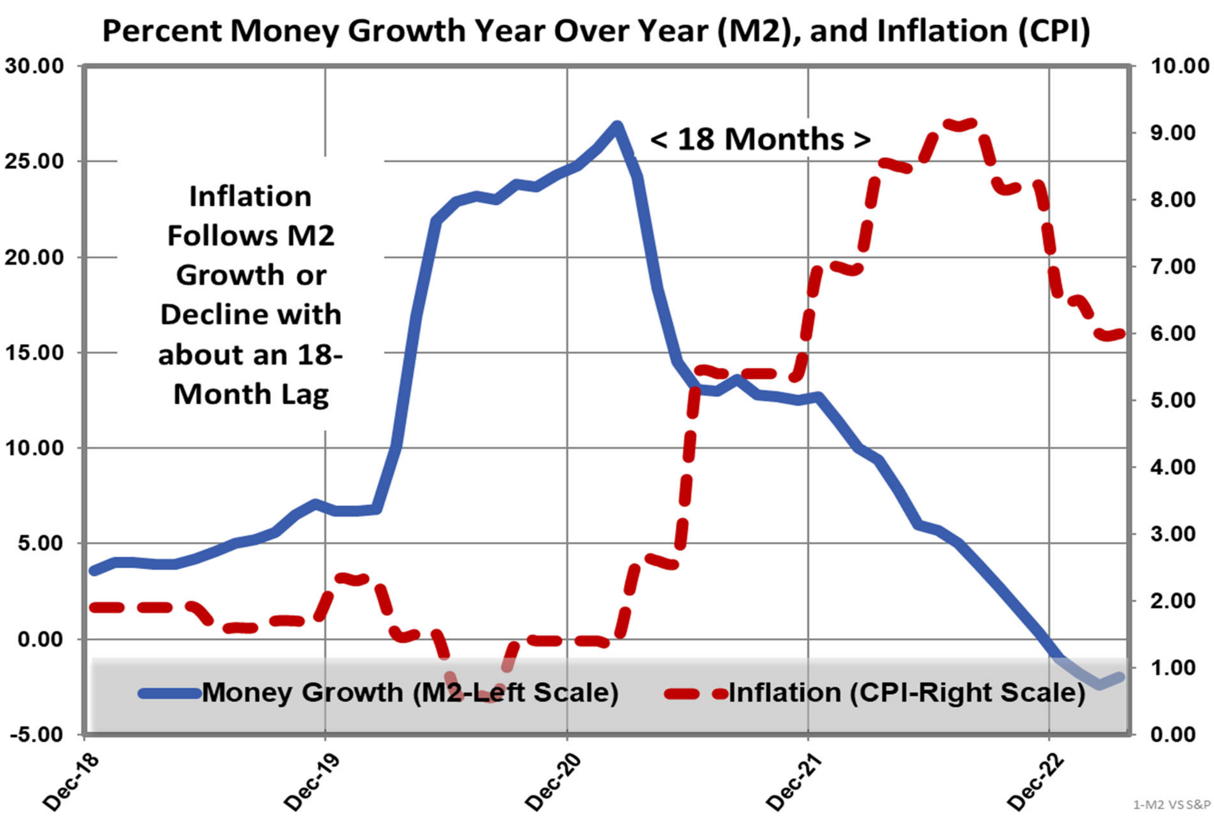


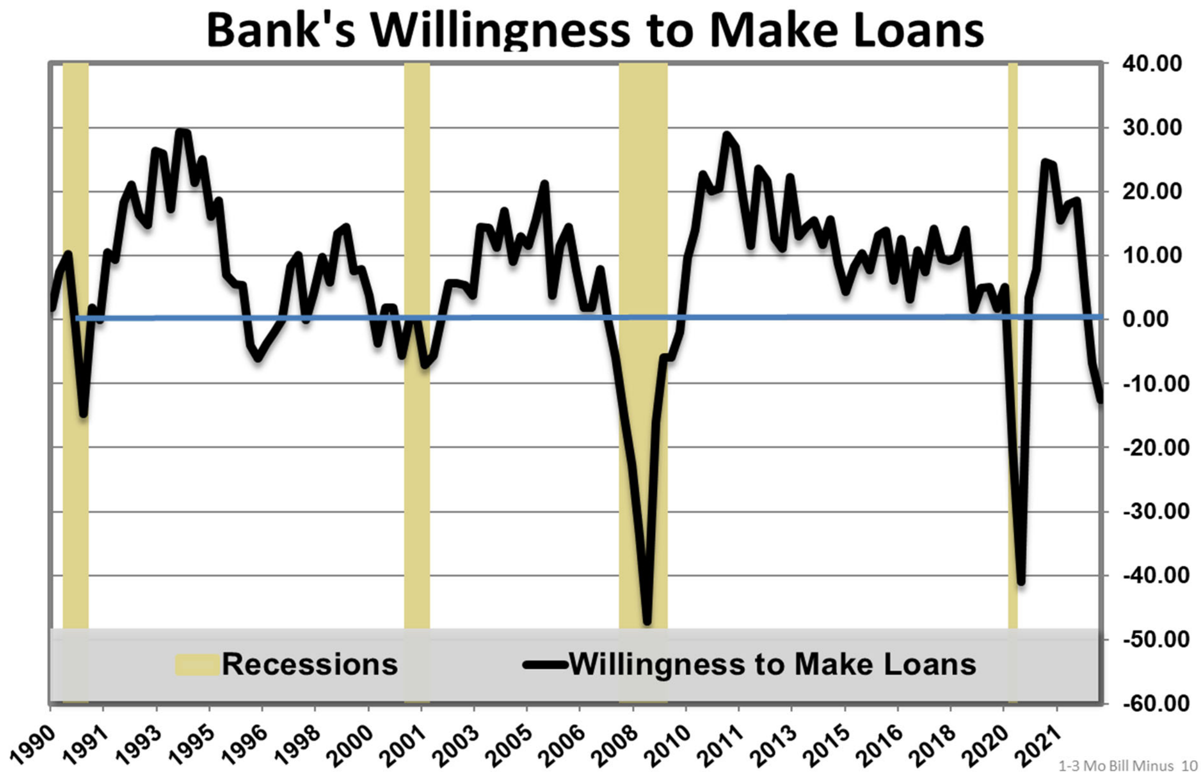
The Atlanta Fed estimates the first quarter annualized real GDP will be 3.2% (see above). Historically aggressive tightening (see below) will affect GDP growth. The Fed's "real" growth estimate for all 2023 is 0.0%, **implying negative "real" growth over the next three quarters.**



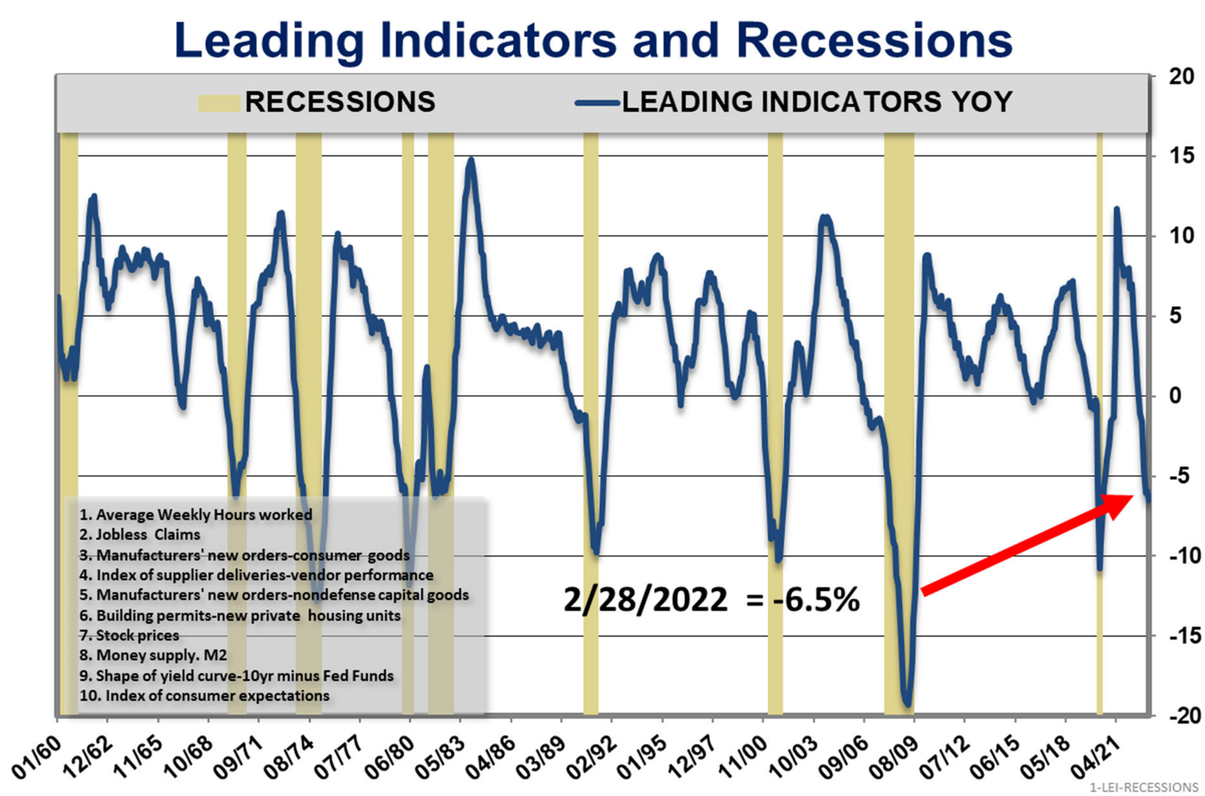


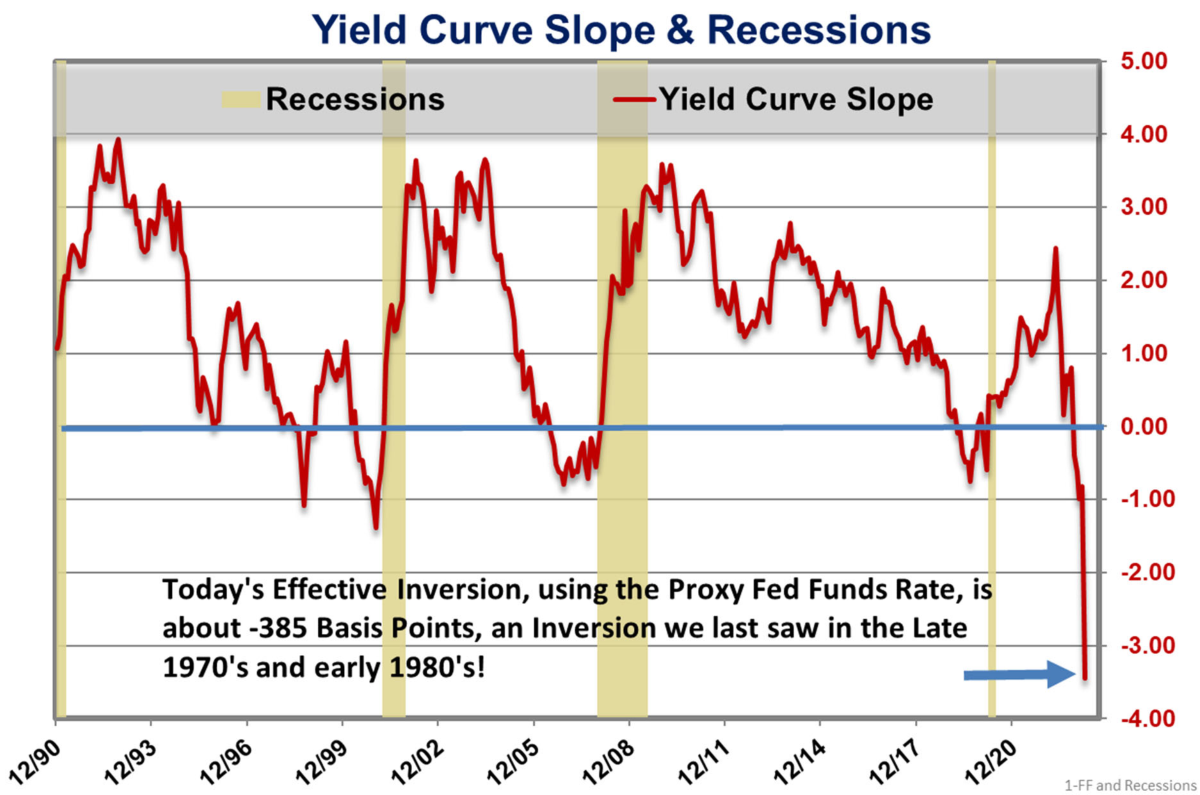
Commodity prices are an important contributor to inflation, and they have clearly rolled over (see above). There is a good, lagging, correlation between M2 growth and inflation (see below).



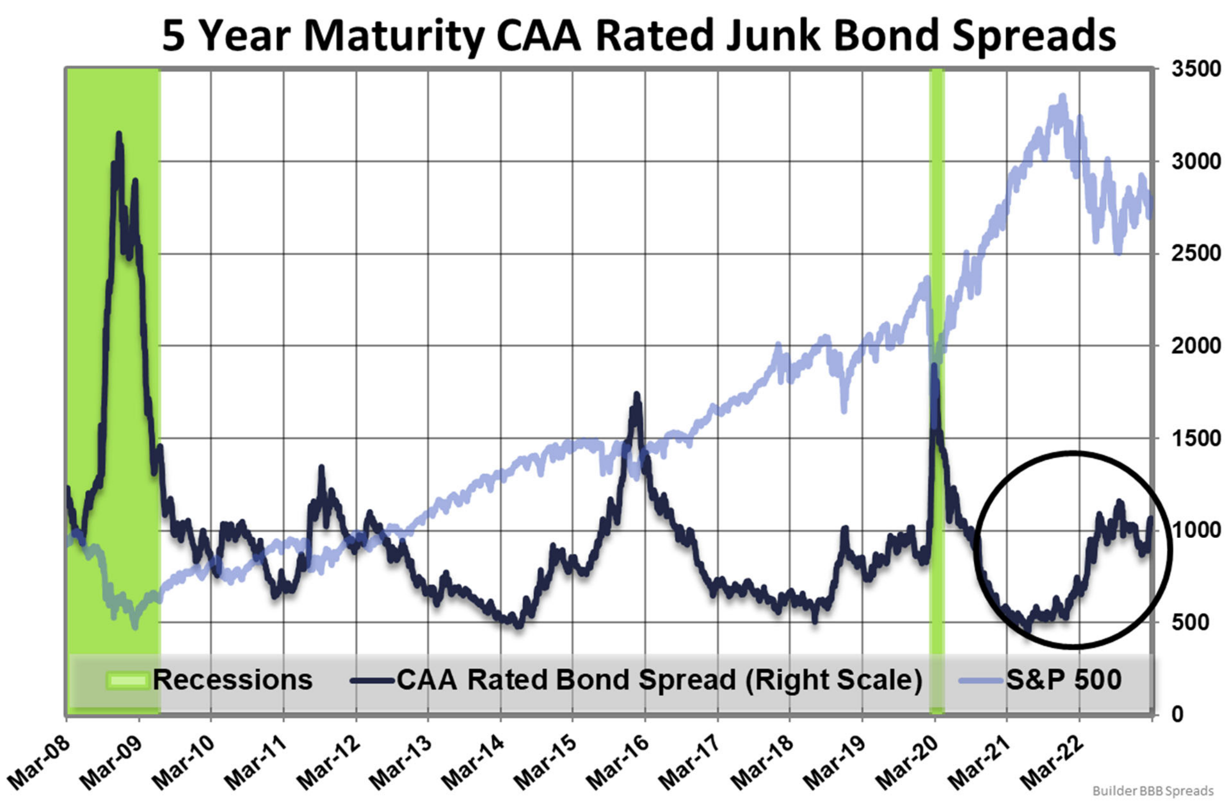


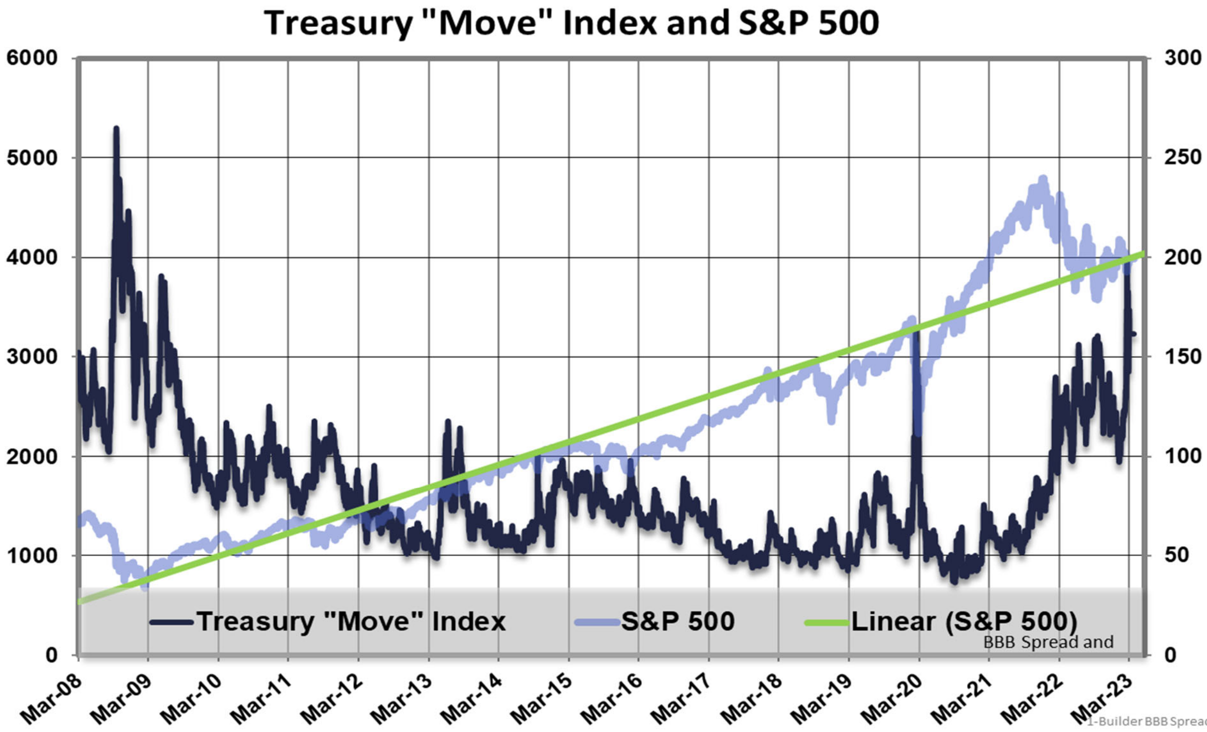
When banks are less willing to make loans, it effectively adds to quantitative tightening (see above), and Leading Indicators are pointing to a near-term recession (see below).



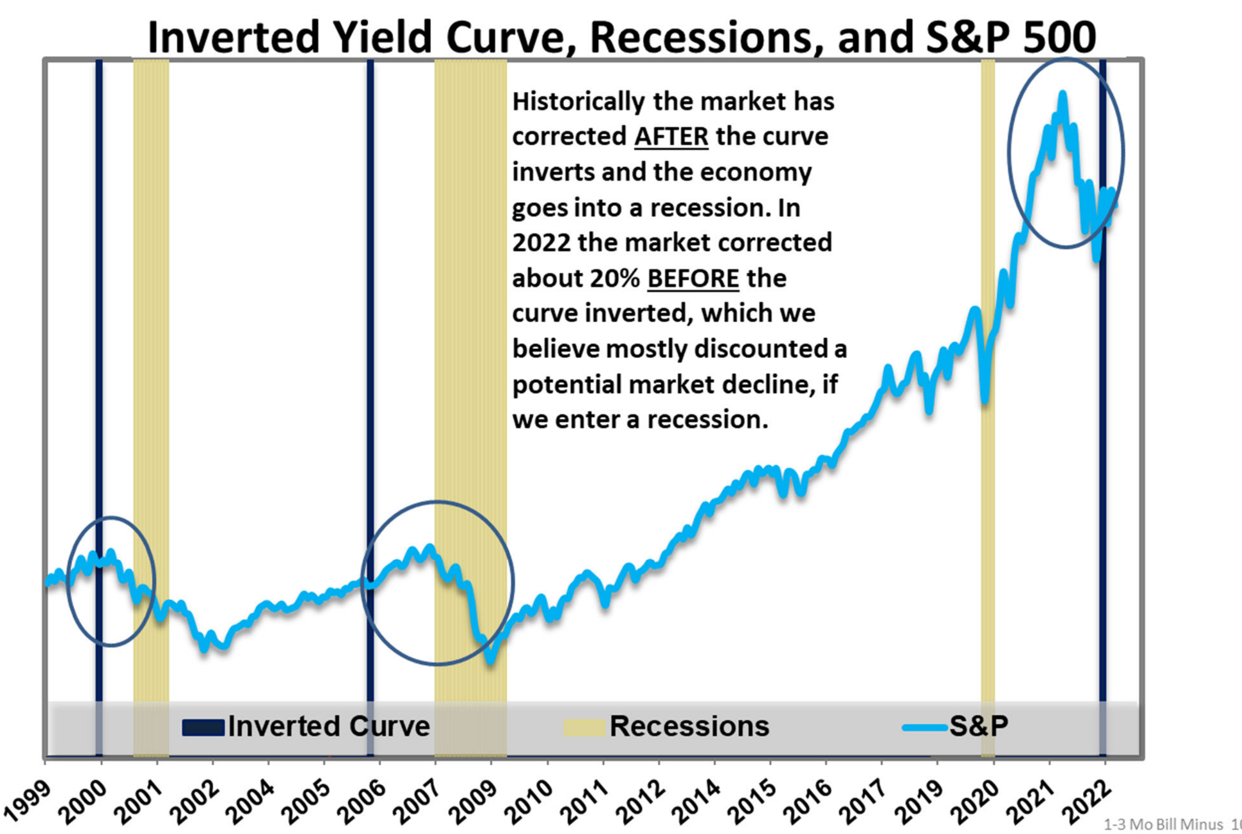


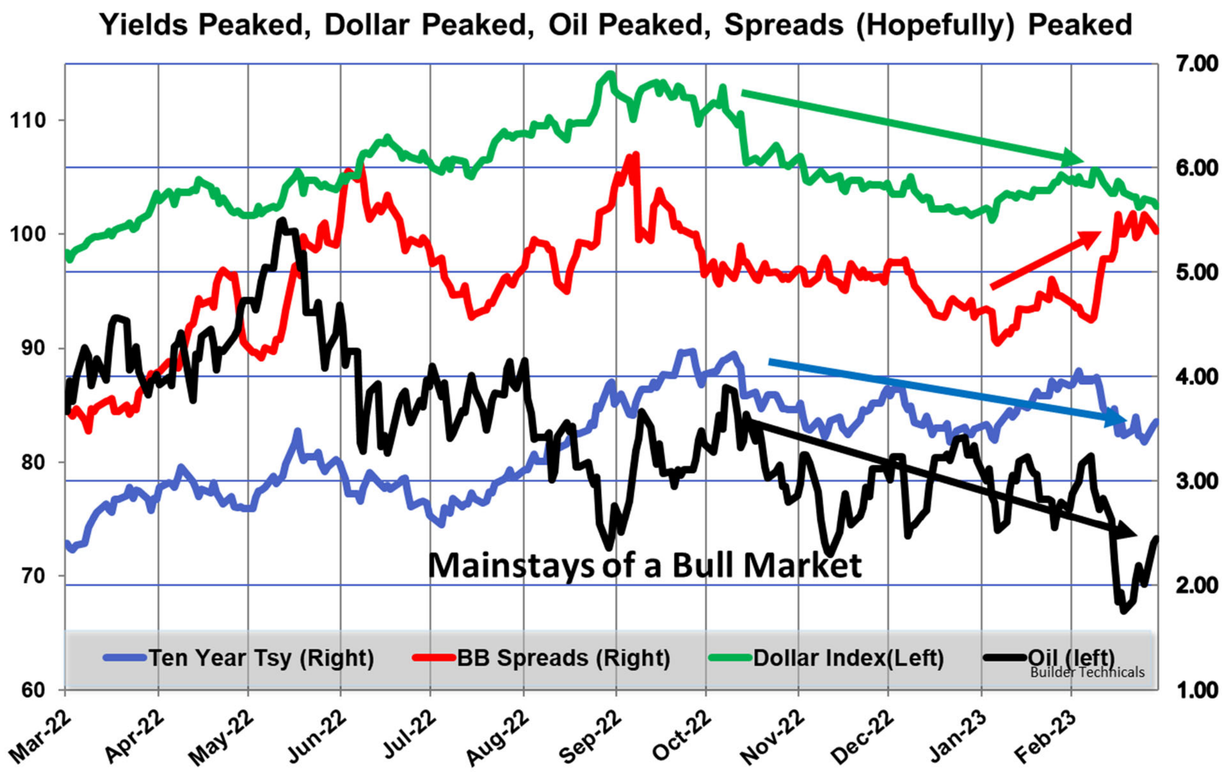
The historically inverted yield curve is predicting a recession (see above). Junk bond spreads widening is seen as a sign of economic stress (see below).



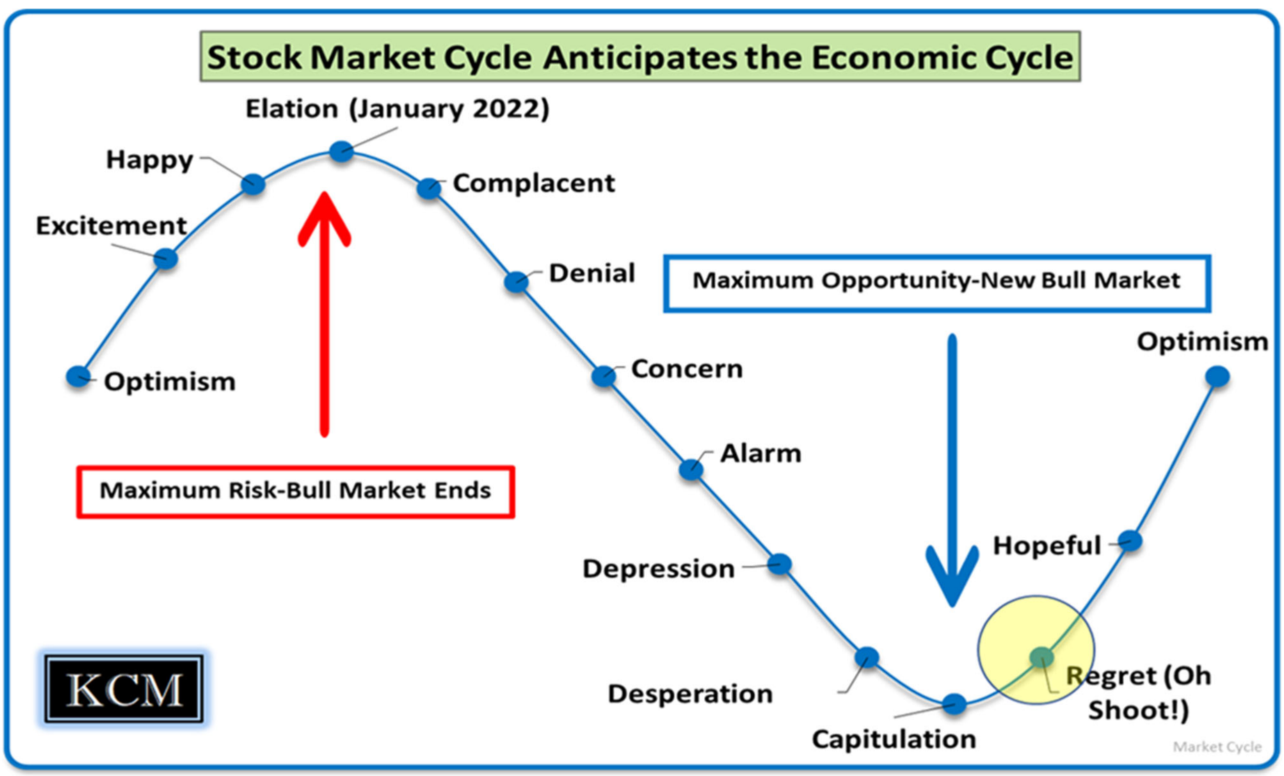


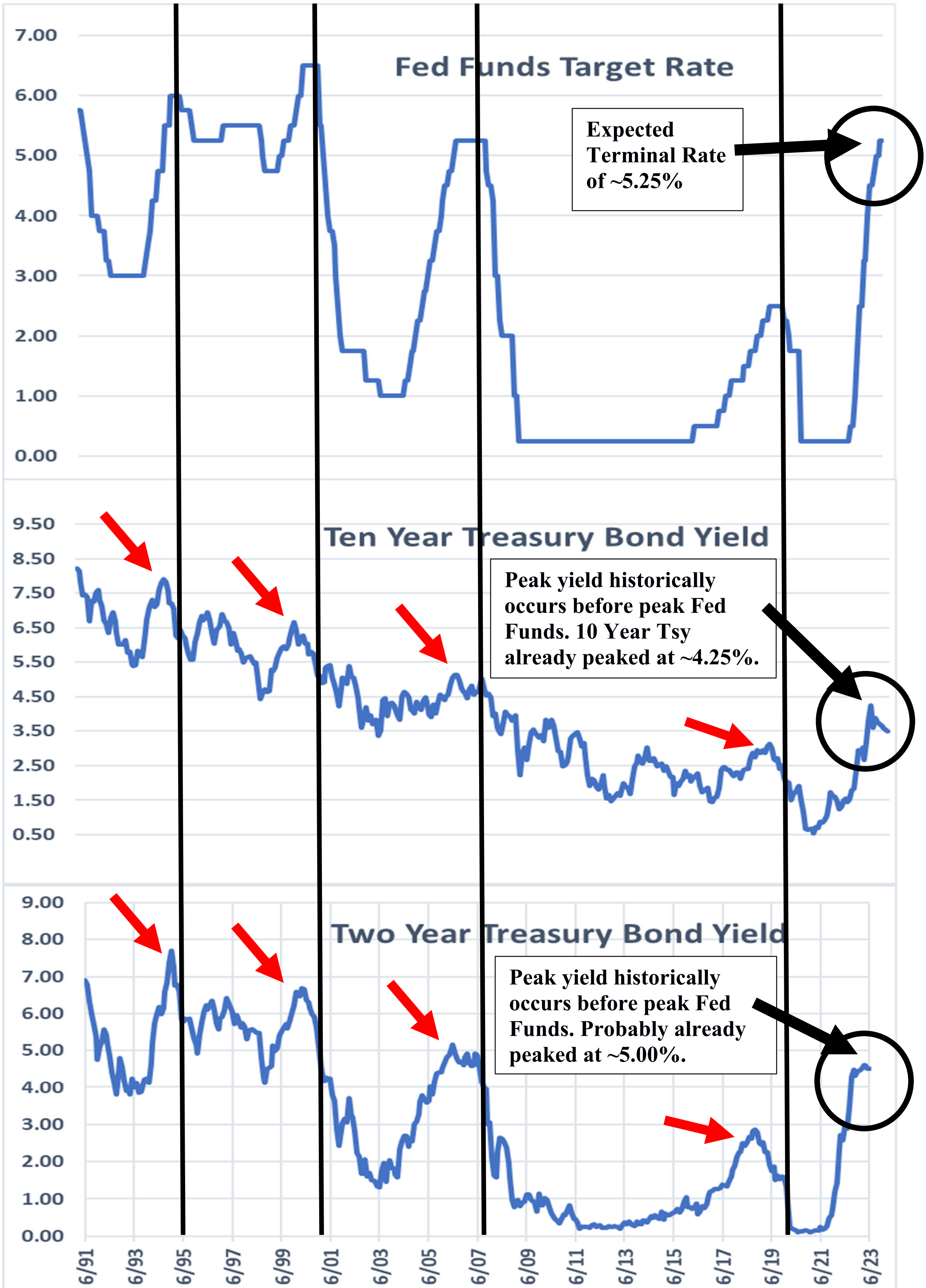
The high level of the "Move Index" is predicting increased market volatility (see above). The 20% market decline last year, before the yield curve inverted, may have mostly discounted any future decline due to a much-anticipated recession (see below).





Three of four mainstays of a bull market are moving in the right direction, but widening junk bond spreads are worrisome (see above). We believe we have seen the stock market lows for this cycle (see below).




Fed Funds Target Rate
7.00
6.00
5.00
4.00
3.00
2.00
1.00
0.00
Expected Terminal Rate of ~5.25%
Ten Year Treasury Bond Yield
9.50
8.50
7.50
6.50
5.50
4.50
3.50
2.50
1.50
0.50
Peak yield historically occurs before peak Fed Funds. 10 Year Tsy already peaked at ~4.25%.
Two Year Treasury Bond Yield
9.00
8.00
7.00
6.00
5.00
4.00
3.00
2.00
1.00
0.00
Peak yield historically occurs before peak Fed Funds. Probably already peaked at ~5.00%.
6/91
6/93
6/95
6/97
6/99
6/01
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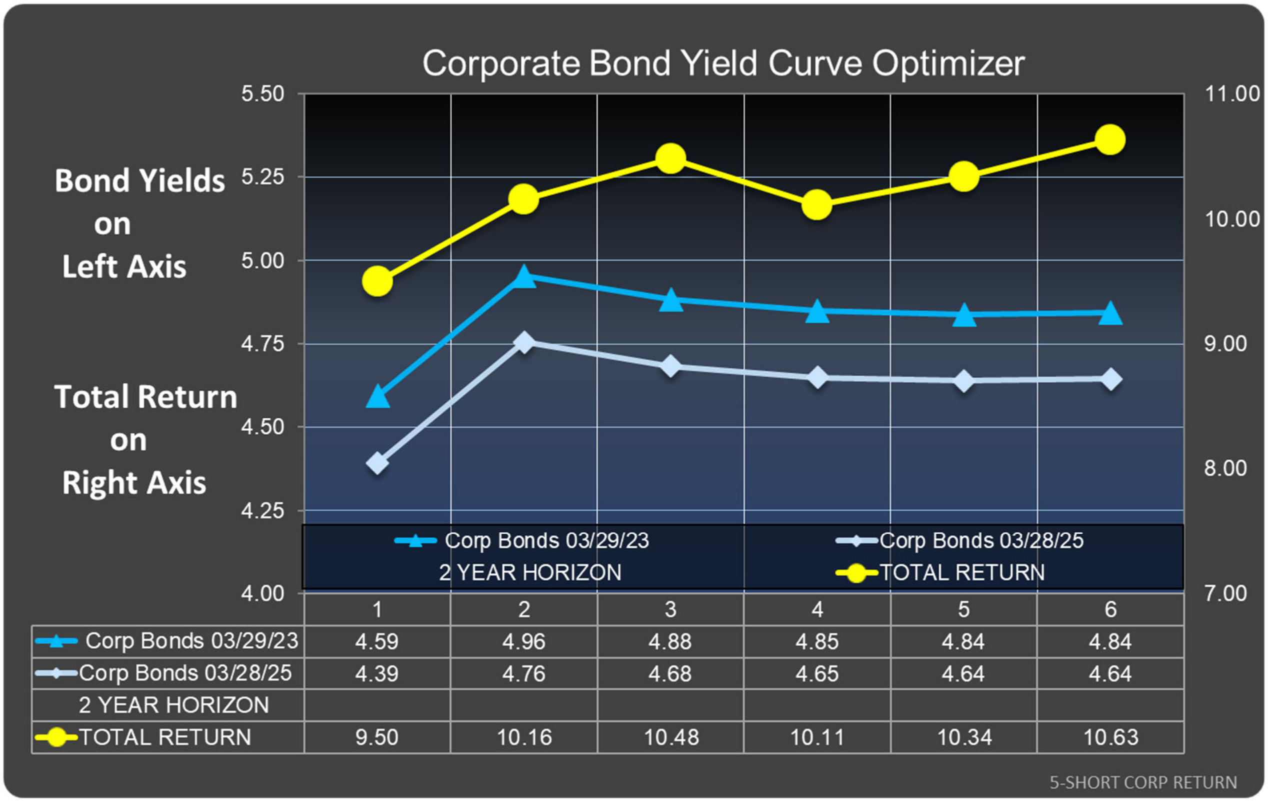
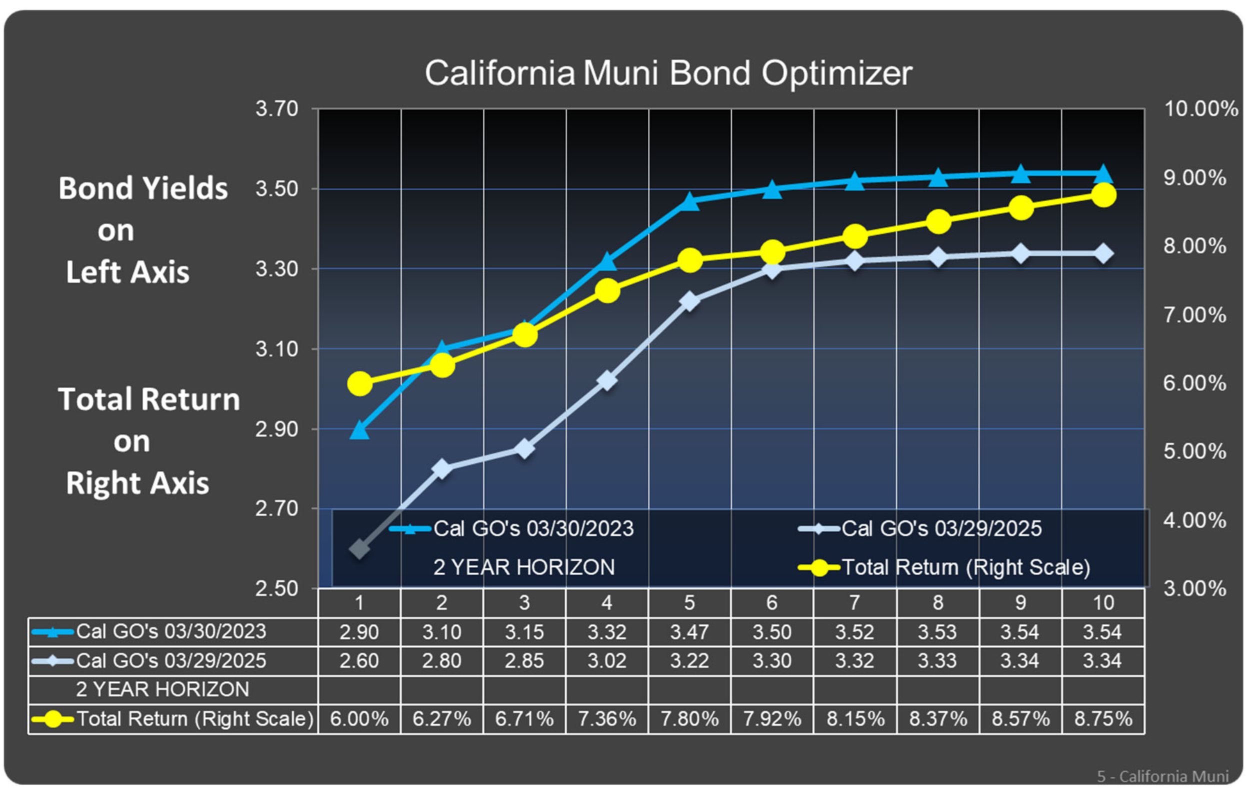


	1	2	3	4	5	6
Corp Bonds 03/29/23	4.59	4.96	4.88	4.85	4.84	4.84
Corp Bonds 03/28/25	4.39	4.76	4.68	4.65	4.64	4.64
2 YEAR HORIZON						
TOTAL RETURN	9.50	10.16	10.48	10.11	10.34	10.63

Both tax-free municipal bonds and taxable corporate bonds still offer a competitive alternative to stocks. A guaranteed 3.5% tax-free yield on an 8 to10-year municipal bond equates to about a 6% annual return on stocks, for a California resident, at current capital gains rates.



	1	2	3	4	5	6	7	8	9	10
Cal GO's 03/30/2023	2.90	3.10	3.15	3.32	3.47	3.50	3.52	3.53	3.54	3.54
Cal GO's 03/29/2025	2.60	2.80	2.85	3.02	3.22	3.30	3.32	3.33	3.34	3.34
2 YEAR HORIZON										
Total Return (Right Scale)	6.00%	6.27%	6.71%	7.36%	7.80%	7.92%	8.15%	8.37%	8.57%	8.75%

KCM	Before & After-Tax Yields					
Call or Maturity	Calif. + Fed. Tax Brackets Federal Tax Brackets	54.0% 37%	50.0% 35%	45.0% 32%	40.0% 24%	35.0% 22%
8-10 Years to Call	CA Muni - Tax Free	3.65	3.65	3.65	3.65	3.65
	CA Muni Taxable Equiv.	7.93	7.30	6.64	6.08	5.62
	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
1-3 years	CA Muni - Tax Free	3.05	3.05	3.05	3.05	3.05
3-5 Years to Maturity	Corp Bond Before-Tax	5.12	5.12	5.12	5.12	5.12
	Corp Bond After-Tax	2.35	2.56	2.81	3.07	3.33
5 Years to Call	Preferreds Before Tax	6.33	6.33	6.33	6.33	6.33
	Preferreds After-Tax	2.91	3.17	3.48	3.80	4.12
10 Year Maturity	Treasuries Before-Tax	3.55	3.55	3.55	3.55	3.55
	Treasuries After-Tax	2.24	2.31	2.41	2.70	2.77

	California Resident Money Market Fund's After-Tax Yld.					
	Calif. + Fed. Tax Brackets Federal Tax Brackets	54.0% 37%	50.0% 35%	45.0% 32%	40.0% 24%	35.0% 22%
SWVXX	SCHWAB VALUE ADV MNY FND	4.61	4.61	4.61	4.61	4.61
	After-Tax	2.12	2.31	2.54	2.77	3.00
SNVXX	SCHWAB GOVT MNY FUND	4.38	4.38	4.38	4.38	4.38
	After-Tax	2.76	2.85	2.98	3.33	3.42
SUTXX	SCHWAB GOVT MNY FUND	4.30	4.30	4.30	4.30	4.30
	After-Tax ($1myn Min.)	2.71	2.80	2.93	3.27	3.36
SCOXX	SCHWAB TSY OBL MNY FND	4.60	4.60	4.60	4.60	4.60
	After-Tax ($1myn Min.)	2.90	2.99	3.13	3.49	3.59
SNOXX	SCHWAB TSY OBL MNY FND	4.45	4.45	4.45	4.45	4.45
	After-Tax	2.80	2.89	3.02	3.38	3.47
SWTXX	SCHWAB NATL MUNI MNY FND	3.63	3.63	3.63	3.63	3.63
	After-Tax	3.01	3.08	3.16	3.05	3.16
SWKXX	SCHWAB CA MUNI MNY FND	3.07	3.07	3.07	3.07	3.07
	After-Tax	3.07	3.07	3.07	3.07	3.07
SNAXX	SCHWAB VALUE ADV MNY FND	4.76	4.76	4.76	4.76	4.76
	After-Tax ($1myn Min.)	2.19	2.38	2.62	2.86	3.10
13063bcs9	Cal. Tax-Free Weekly Floater	3.65	3.65	3.65	3.65	3.65
882724gk7	National Weekly Floater	4.80	4.80	4.80	4.80	4.80
	National - After Cal. Tax	3.98	4.08	4.18	4.03	4.18

Wrapping up: Investors Should Stay the Course

- On March 22nd the Federal Reserve made an unprecedented rate hike despite many signs that the current crisis is not over and history's lesson that crises do not end until the Fed at least pauses.
- The Atlanta Fed is estimating a first quarter real GDP growth rate of 3.2%. The Fed's estimate for all of 2023 is 0.00%, implying there may be negative real growth over the next three calendar quarters.
- The Proxy Funds Rate, calculated by the San Francisco Federal Reserve Bank, is about 7.0% versus the actual Fed Funds rate of 5.00%, reflecting the additional influence of the Fed's quantitative tightening and likely bank credit tightening.
- Commodity prices, which include items such as oil, gas, and agricultural products, can have a significant impact on the cost of producing goods and services. When commodity prices rise, companies may need to charge more for their products to cover their increased costs, which can lead to inflationary pressures. Conversely, when commodity prices fall, it can help to bring down inflationary pressures.
- There is a correlation between money supply growth and inflation. When there is more money available to spend, people may be willing to pay more for goods and services, which can lead to higher inflation. Negative money supply growth, such as we see now, has the opposite effect.
- When banks are less willing to lend money, it can put a damper on economic growth and contribute to quantitative tightening. This is because loans are a major source of money creation in the economy. When banks make loans, they create new money by adding that loan amount to their customers' accounts. This increases the overall money supply in the economy and can stimulate economic activity. However, when banks are less willing to make loans, this can reduce the amount of new money being created and effectively tighten the money supply. This can lead to a slowdown in economic growth and put downward pressure on inflation.
- While some leading indicators and a historically inverted yield curve may suggest a downturn is on the horizon, others may indicate that growth will continue. Also, the likelihood of any recession can vary depending on how policymakers respond.
- The widening of junk bond spreads is commonly seen as a sign of economic stress or uncertainty. Junk bonds are issued by companies with lower credit ratings, which makes them riskier investments. When investors become more nervous about the economy or the financial health of companies, they demand higher yields to compensate for the increased risk. This drives up the spreads between junk bonds and Treasury bonds, which are considered safer investments. Widening spreads can be an indicator of economic turbulence or uncertainty.
- The Treasury "Move Index" is a measure of implied volatility in the US Treasury bond market. Today's elevated level suggests market participants are pricing in an increased possibility of events that would cause a sudden market shock.

- The Fed has never forecasted a recession until now. Their current forecast is for a recession starting this year, 2023.
- It is possible the 20% market decline that occurred last year, while Fed Funds were still at about 1%, but anticipating rate increases and quantitative tightening, mostly discounted any future decline due to a much-anticipated recession in 2023.
- Three of our four mainstays of a bull market, declining ten-year Treasury bond yields, plummeting oil prices, and a weakening dollar, are moving in the right direction, widening junk bond spreads are worrisome.
- We have likely seen the peak in Treasury bond yields (see the charts on page 8).
- Both tax-free municipal bonds and taxable corporate bonds still offer a competitive alternative to stocks. A guaranteed 3.5% tax-free yield on an 8 to10-year municipal bond equates to about a 6% annual return on stocks, for a California resident.
- Higher than expected inflation is what got us into this mess and largely caused last year's market correction. But inflation is clearly declining, and the stock market cycle has likely bottomed out and is looking forward to better times.
- We believe the Fed's current Fed Funds rate, forward guidance, and quantitative tightening path are sufficient to reduce inflation to an acceptable level.
- Our advice has not changed. Stay the course, add to your equities during a bottoming market cycle, and take solid comfort locking in some of today's attractive bond yields.

As always, we are glad to discuss your questions or concerns, and would like to thank you again for investing with KCM. It is our constant goal to exceed your expectations.

Jay Kellett

Founder & CEO

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