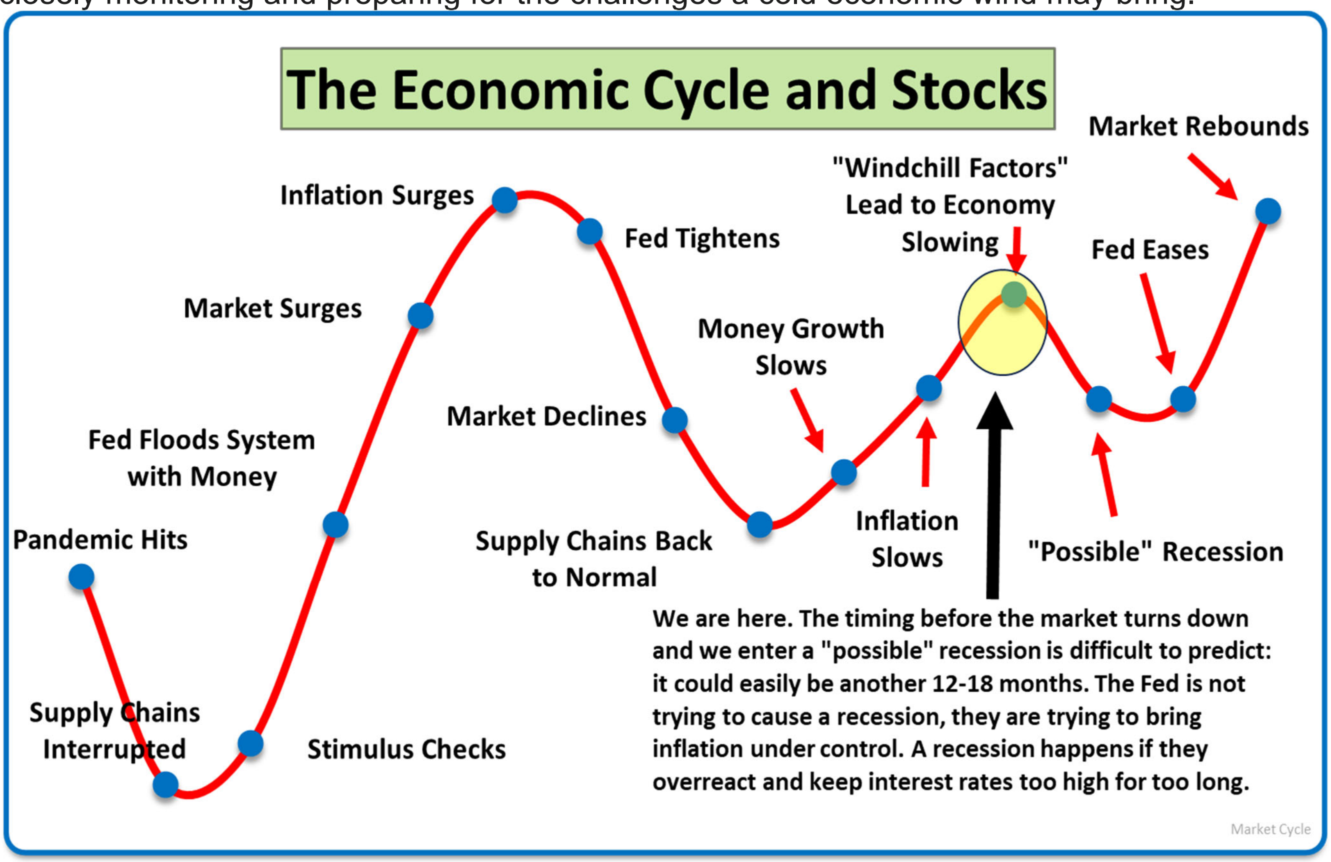
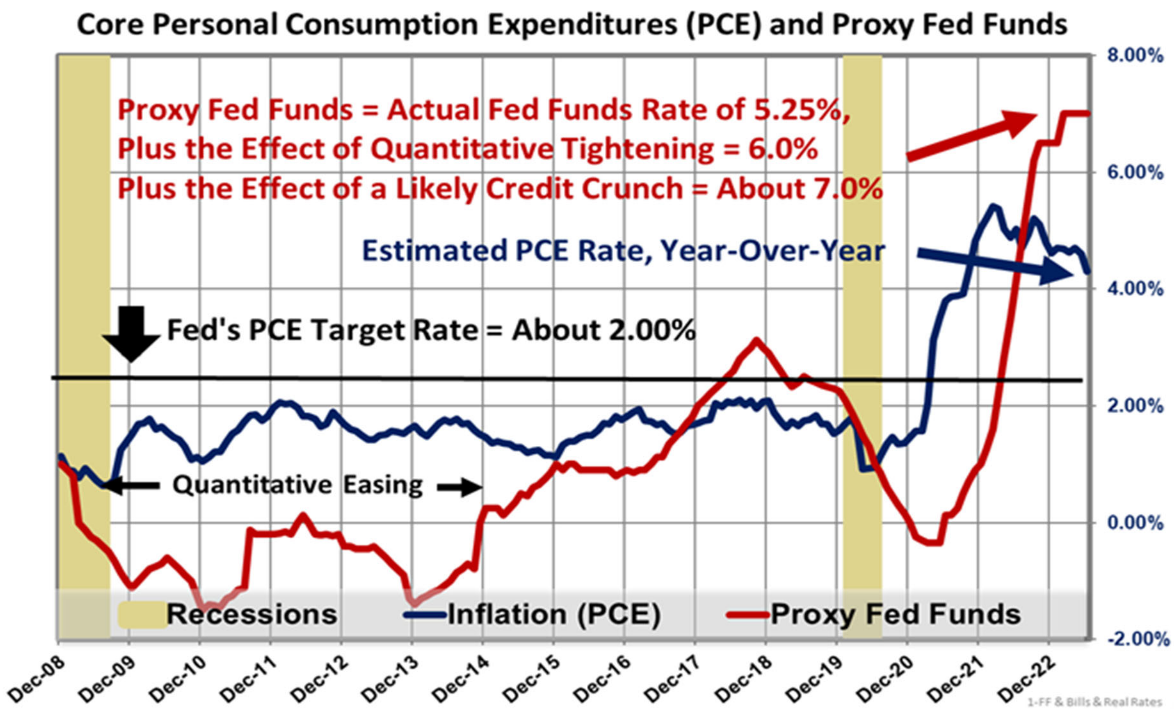
The Windchill Factor

The windchill factor is a measure of how much colder it feels outside when the wind is blowing. Accounting for the windchill factor is important because the colder the air temperature and the more aggressive the wind, the greater the risk of frostbite. Similarly, the more aggressive the Fed's tightening, a cold wind, the more likely it is to cause a recession.

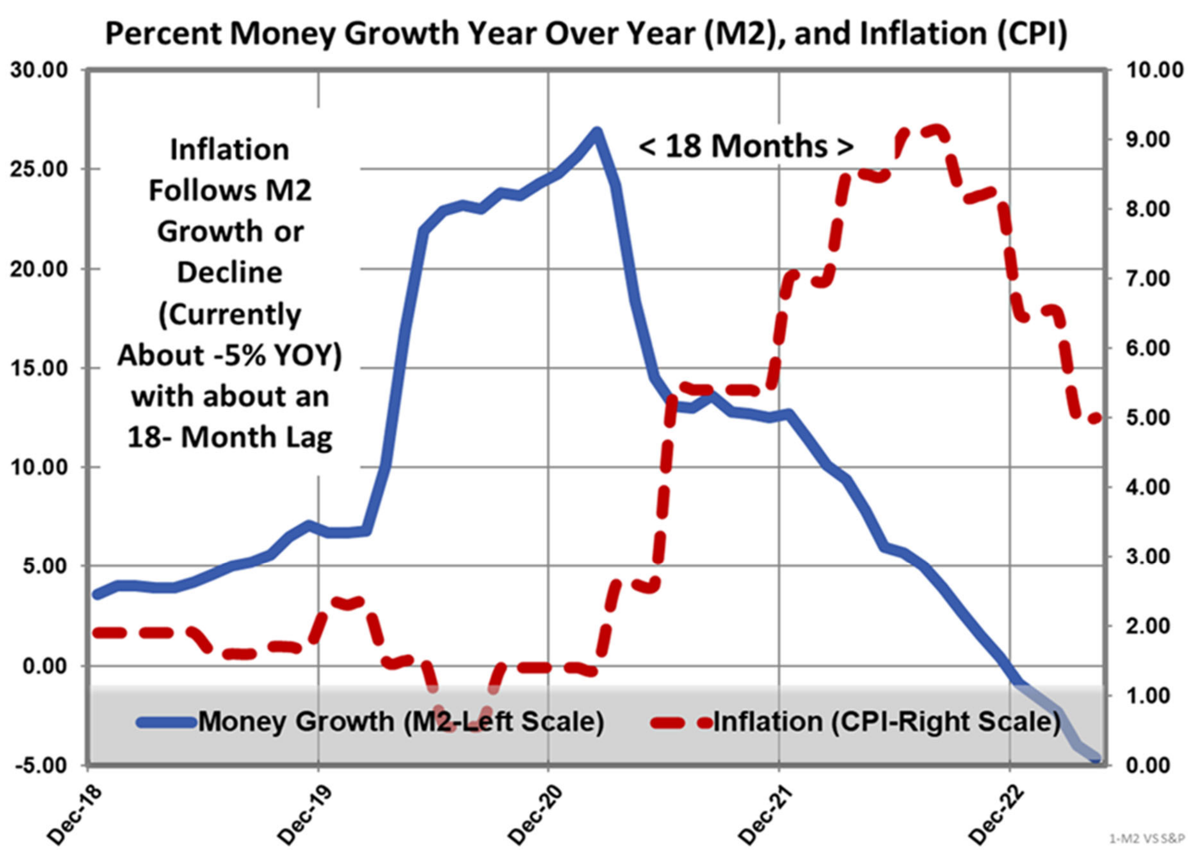
The Fed's tightening has not yet caused the U.S. economy to freeze up, a warm economic breeze is still blowing. We have had three quarters of positive real GDP growth, and the Atlanta Fed estimates a 1.77% gain for this quarter. The unemployment rate is a historically low 3.7%, and job openings remain surprisingly robust. Consumers are still recovering from the pandemic, spending their excess savings on travel and especially services. Income growth is solid, and consumer debt service payments are only 9.6% of disposable income. Fiscal spending remains a strong counterweight to the Fed's tightening and will continue to support growth by injecting hundreds of billions of dollars into the economy. The stock market has been strong for the last nine months, boosting consumer confidence and spending.

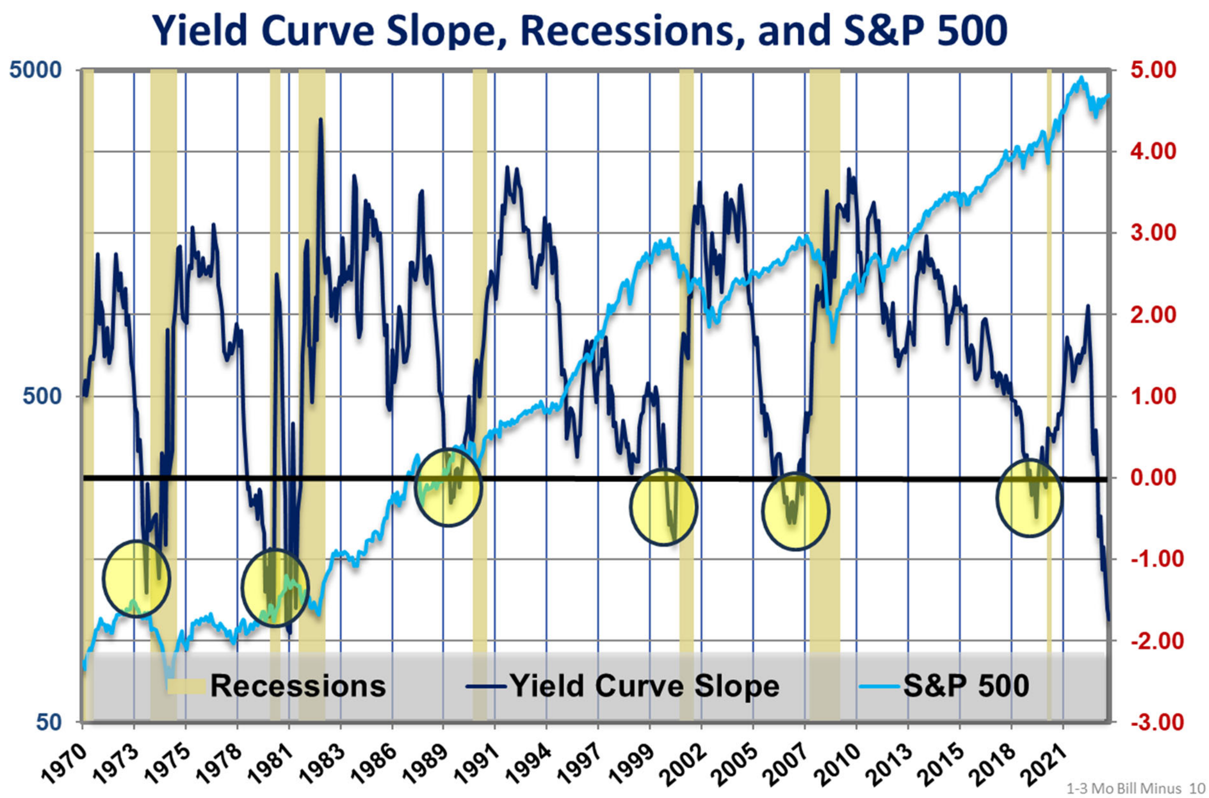
The "windchill factors" illustrated on the following pages may have a profound effect on the current U.S. economy. The timing is tough to predict and can change rapidly, but KCM will be closely monitoring and preparing for the challenges a cold economic wind may bring.



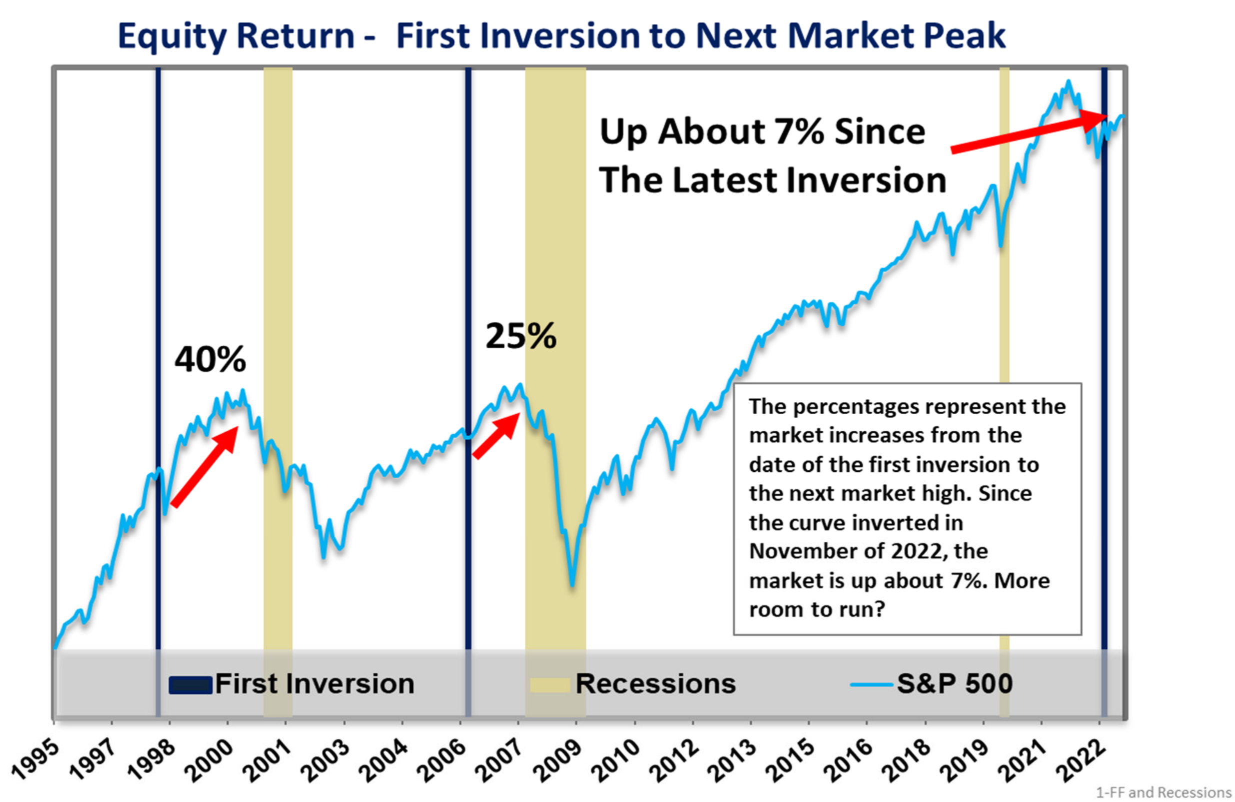


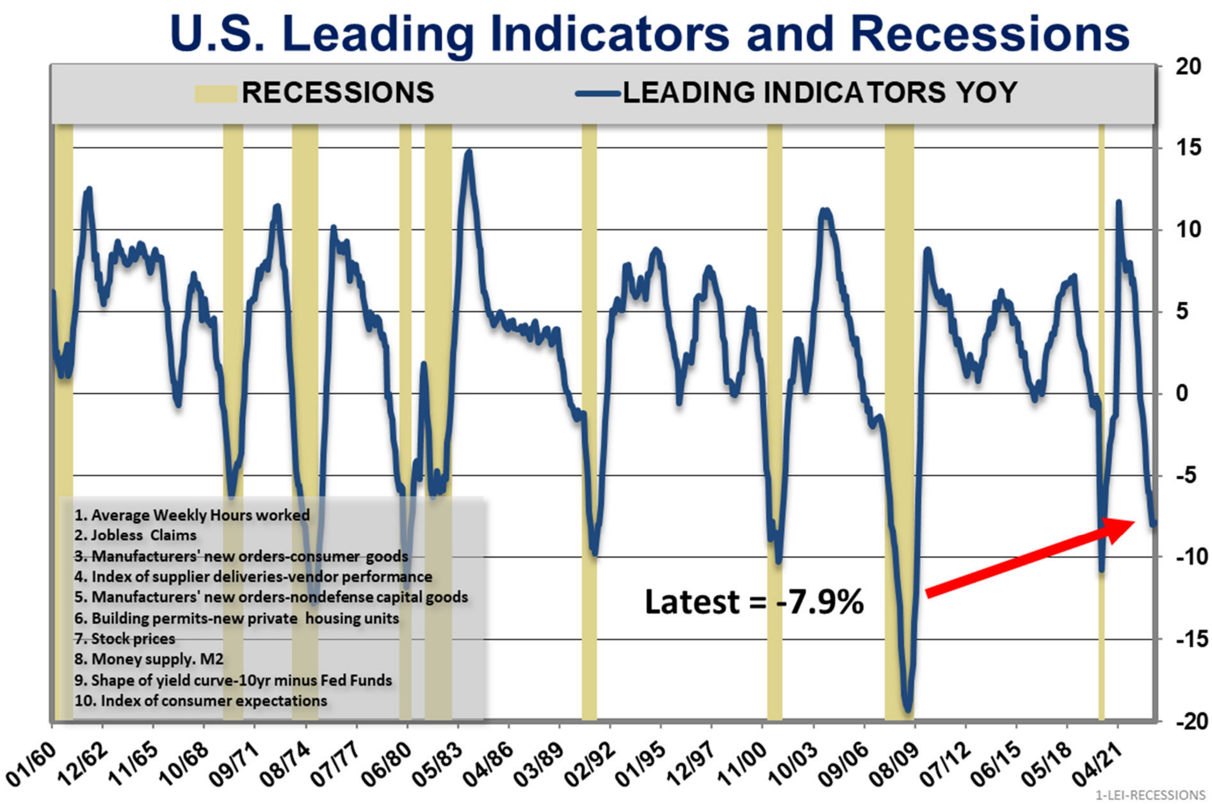
The Fed's Quantitative Tightening (QT), plus an all-in proxy Fed Funds rate approaching 7.00% (see above), are likely to put downward pressure on the U.S. economy and slow inflation (see below). QT is the process of reducing the Fed's balance sheet by not reinvesting Treasury bond and mortgage maturities. This reduces the amount of money in circulation (M2).



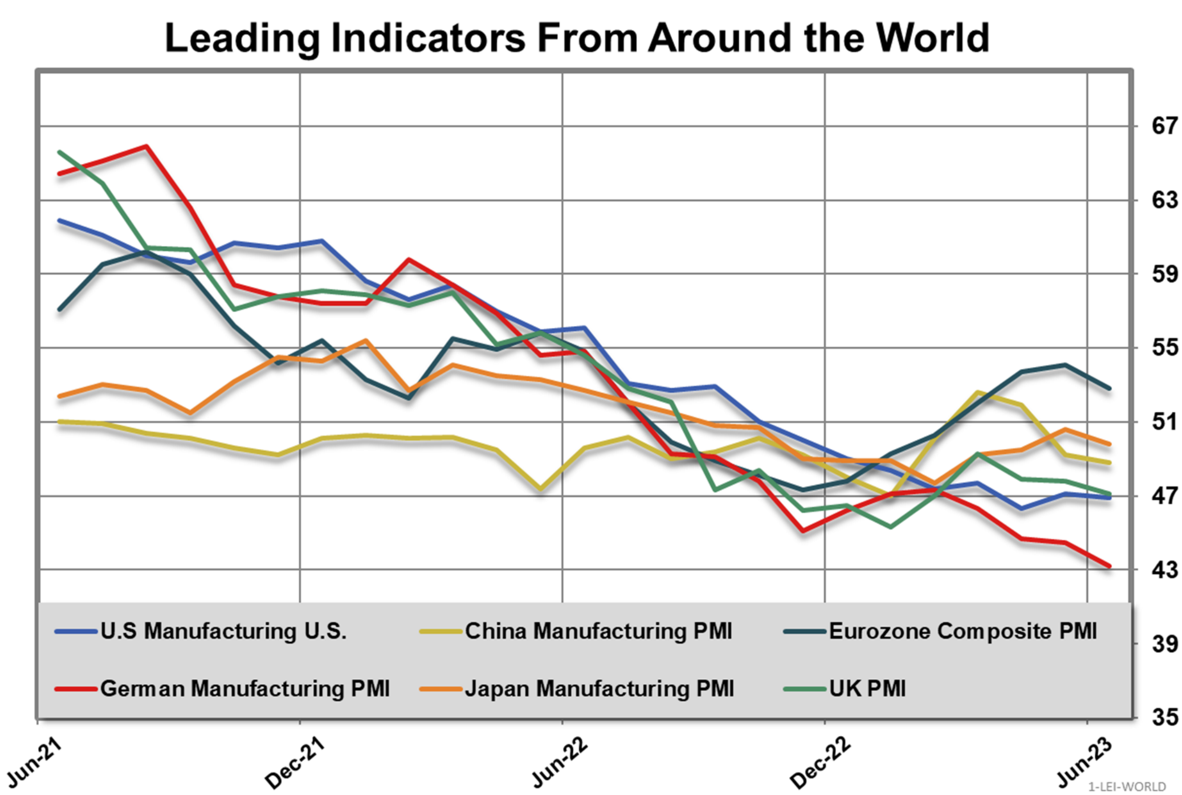


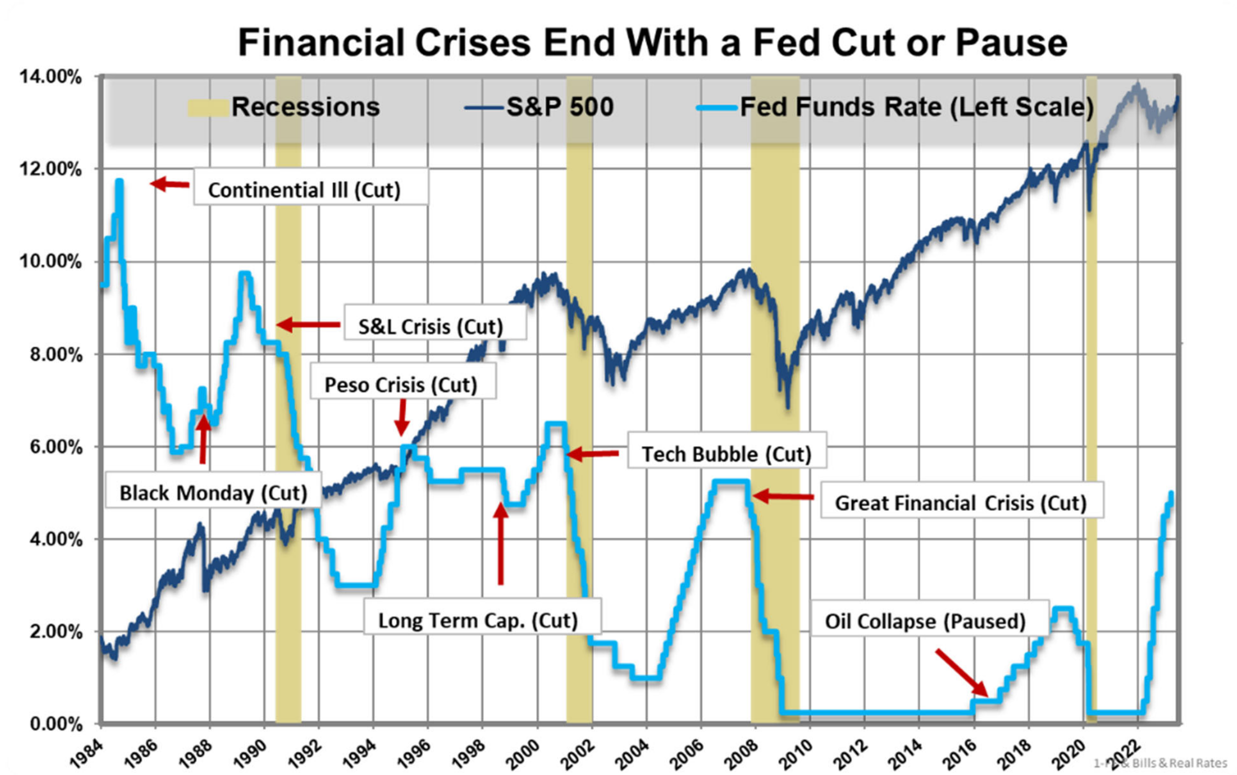
History tells us an inverted yield curve is a reliable predictor of a recession (see above). History also tells us the market can have a substantial rally from the date of the inversion to when a recession starts (see below).



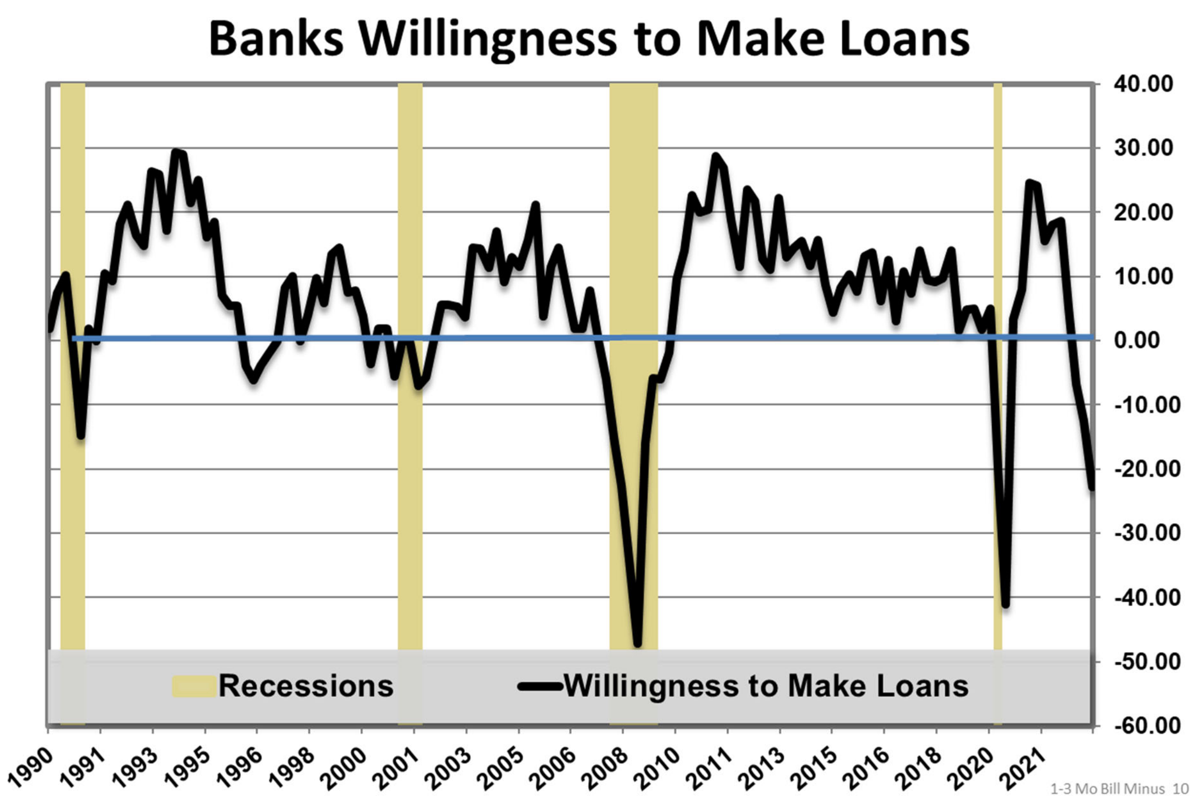


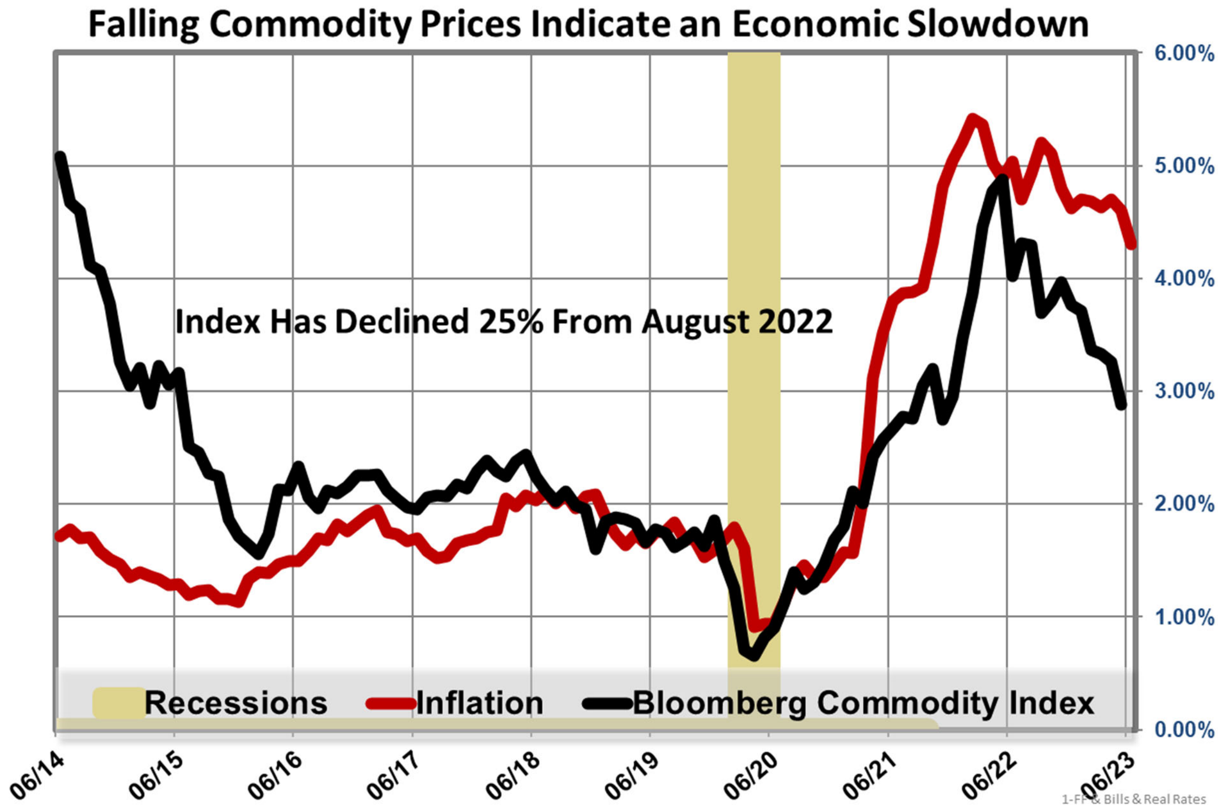
The rollover of leading economic indicators in the U.S. (see above), and from around the world (see below), augurs for an economic windchill.



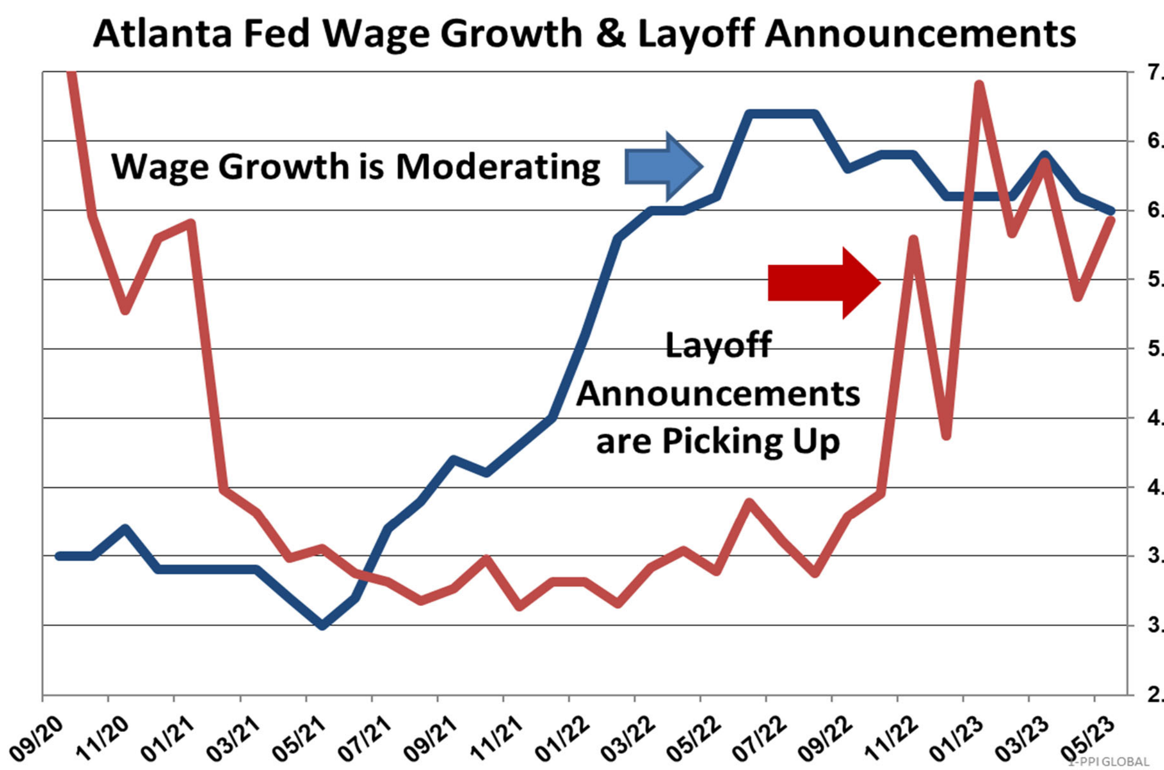


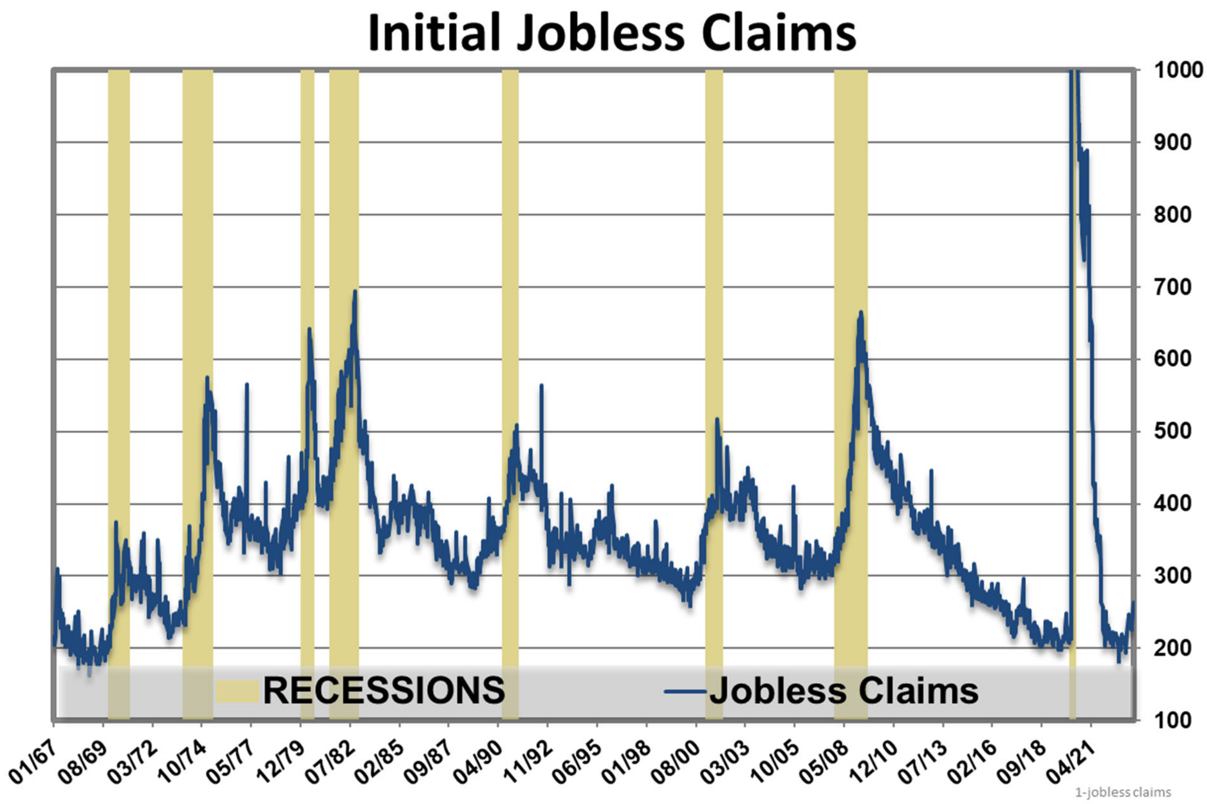
Fed tightening cycles can lead to a financial crisis, (see above) followed by a Fed interest rate pause or cut. We had a regional banking crisis in early March, but the Fed did not pause or cut rates. Continued pressure on the banks has reduced their willingness to make loans, (see below) another windchill factor.



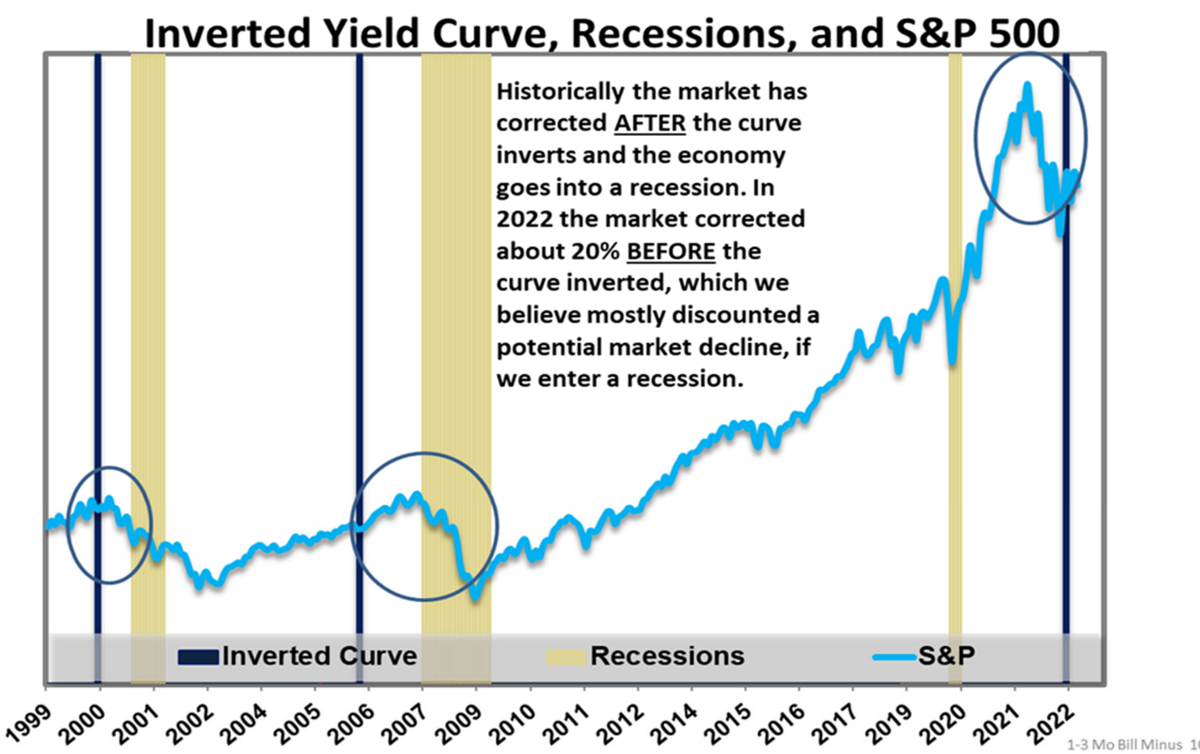


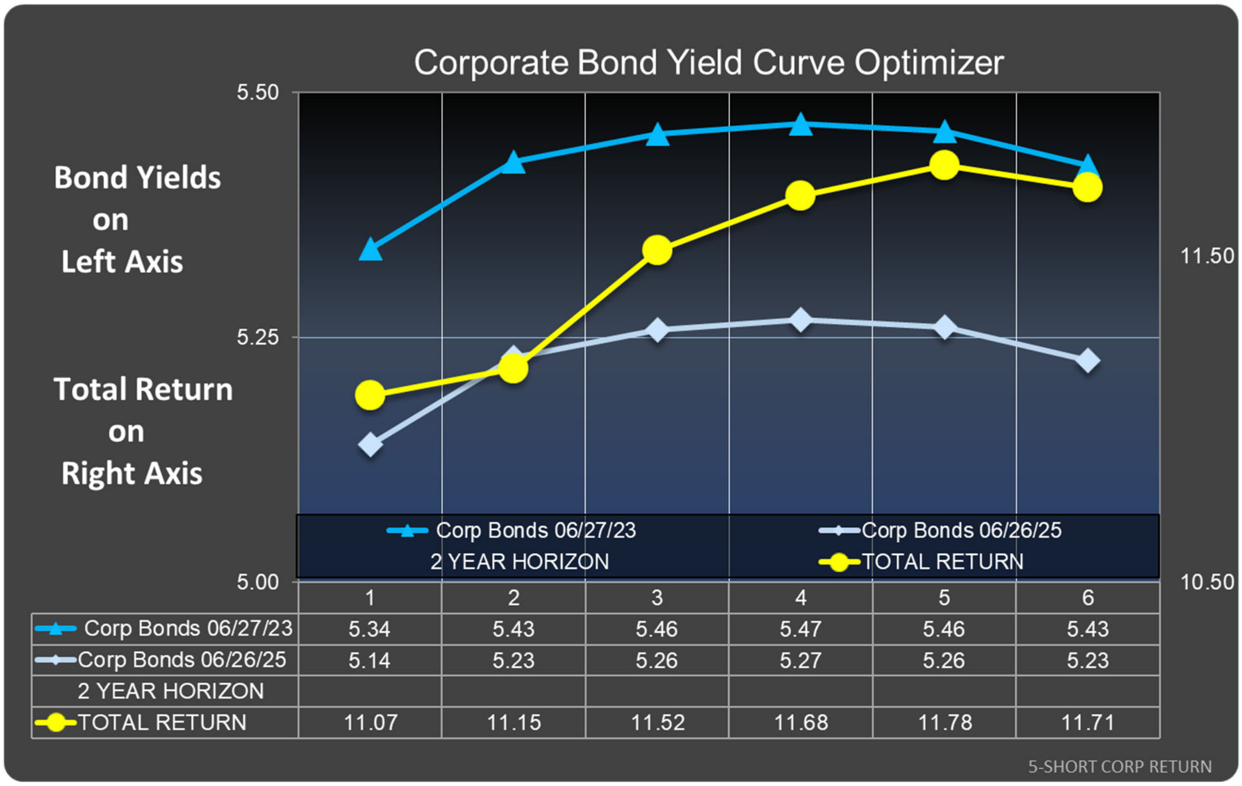
Falling commodity prices (see above) and increasing layoff announcements (see below) can be an indicator of a slowing economy. Falling commodity prices and moderating wage growth can lead to lower inflation.





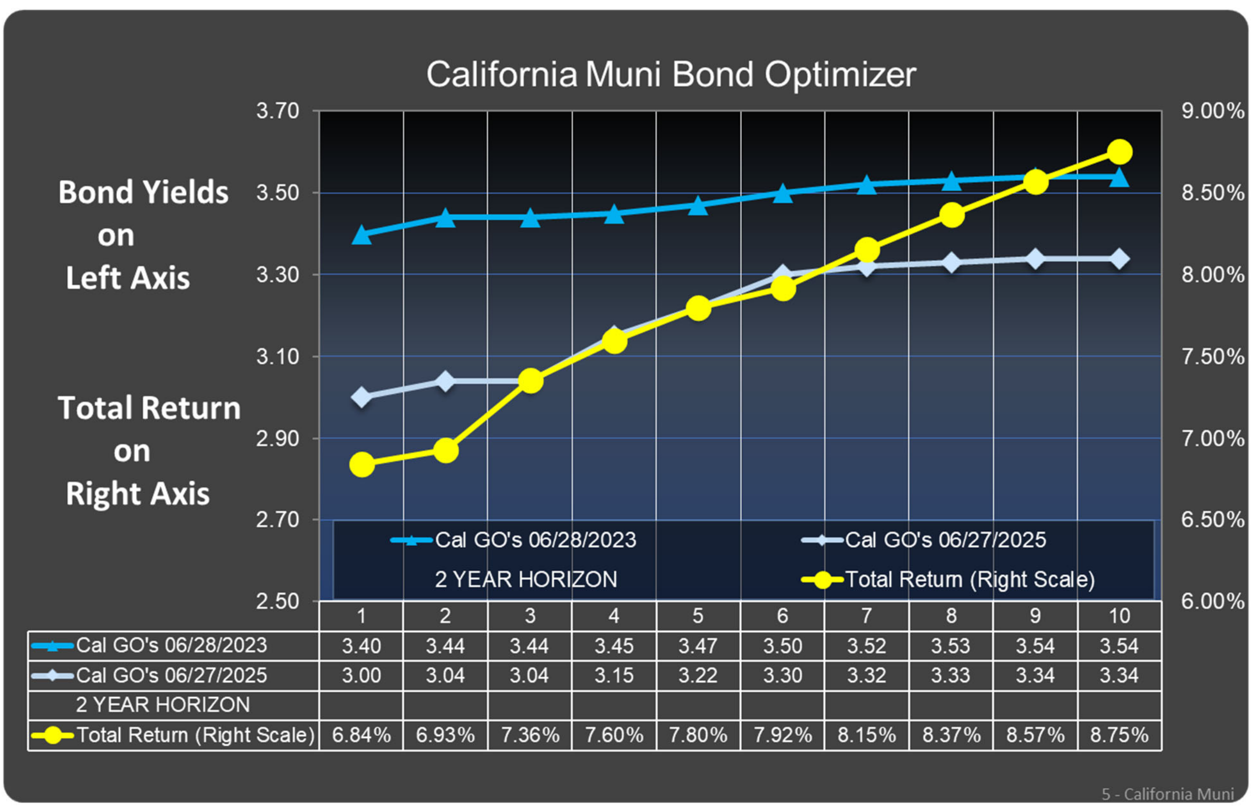
Jobless claims are increasing but need to be at a higher number before they are a good indicator that we are close to a recession (see above). Even if we do enter a recession the stock market decline may be muted because the market has been anticipating a future recession since early 2022 and has already corrected sharply (see below).





	1	2	3	4	5	6
Corp Bonds 06/27/23	5.34	5.43	5.46	5.47	5.46	5.43
Corp Bonds 06/26/25	5.14	5.23	5.26	5.27	5.26	5.23
2 YEAR HORIZON						
TOTAL RETURN	11.07	11.15	11.52	11.68	11.78	11.71

Tax-free municipal bonds and taxable corporate bonds can still be competitive alternatives to stocks. For example, a 3.5% tax-free yield on an 8- to 10-year municipal bond is equivalent to a 6% annual return on stocks for a California resident, at current tax rates.



	1	2	3	4	5	6	7	8	9	10
Cal GO's 06/28/2023	3.40	3.44	3.44	3.45	3.47	3.50	3.52	3.53	3.54	3.54
Cal GO's 06/27/2025	3.00	3.04	3.04	3.15	3.22	3.30	3.32	3.33	3.34	3.34
2 YEAR HORIZON										
Total Return (Right Scale)	6.84%	6.93%	7.36%	7.60%	7.80%	7.92%	8.15%	8.37%	8.57%	8.75%

	California Resident Money Market Fund's After-Tax Yld.					
	Calif. + Fed. Tax Brackets	54.0%	50.0%	45.0%	40.0%	35.0%
	Federal Tax Brackets	37%	35%	32%	24%	22%
SWVXX	SCHWAB VALUE ADV MNY FND	4.93	4.93	4.93	4.93	4.93
	After-Tax	2.27	2.47	2.71	2.96	3.21
SNVXX	SCHWAB GOVT OBLIGATIONS	4.77	4.77	4.77	4.77	4.77
	After-Tax	3.01	3.10	3.24	3.63	3.72
SUTXX	SCHWAB TSY ONLY FUND	4.96	4.96	4.96	4.96	4.96
	After-Tax ($1myn Min.)	3.12	3.22	3.37	3.77	3.87
SCOXX	SCHWAB TSY OBLIGATIONS	4.94	4.94	4.94	4.94	4.94
	After-Tax ($1myn Min.)	3.11	3.21	3.36	3.75	3.85
SNOXX	SCHWAB GOVT OBLIGATIONS	4.79	4.79	4.79	4.79	4.79
	After-Tax	3.02	3.11	3.26	3.64	3.74
SWTXX	SCHWAB NATL MUNI MNY FND	3.76	3.76	3.76	3.76	3.76
	After-Tax	3.12	3.19	3.27	3.16	3.27
SWKXX	SCHWAB CA MUNI MNY FND	2.95	2.95	2.95	2.95	2.95
	After-Tax	2.95	2.95	2.95	2.95	2.95
SNAXX	SCHWAB VALUE ADV MNY FND	5.08	5.08	5.08	5.08	5.08
	After-Tax ($1myn Min.)	2.34	2.54	2.79	3.05	3.30
13063bcs9	Cal. Tax-Free Weekly Floater	3.00	3.00	3.00	3.00	3.00
882724gk7	National Weekly Floater	4.00	4.00	4.00	4.00	4.00
	National - After Cal. Tax	3.32	3.40	3.48	3.36	3.48
90 Day T-Bill	Three Month Treasury Bill	5.32	5.32	5.32	5.32	5.32
	T-Bill After Federal Tax	3.35	3.45	3.61	4.04	4.15

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	3.65	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	5.71	5.71	5.71	5.71	5.71
	Corp Bond After-Tax	2.63	2.85	3.14	3.42	3.71
5 Years to Call	Preferreds Before Tax	6.02	6.02	6.02	6.02	6.02
	Preferreds After-Tax	2.77	3.01	3.31	3.61	3.92
10 Year Maturity	Treasuries Before-Tax	3.74	3.74	3.74	3.74	3.74
	Treasuries After-Tax	2.36	2.43	2.54	2.84	2.92

Wrapping up:

- The Fed's Quantitative Tightening (QT) and the all-in proxy Fed Funds rate, approaching 7.00%, are likely to put downward pressure on the U.S. economy. QT is the process of reducing the Fed's balance sheet by not reinvesting bond maturities and selling assets, such as Treasury bonds and mortgage-backed securities. This reduces the amount of money in circulation, which can lead to slower economic growth.
- The all-in proxy Fed Funds rate is a measure of the overall cost of borrowing money in the United States. It is calculated as the sum of the current Fed Funds rate, the effect of quantitative tightening, and KCM's estimate of the effects of a credit crunch.
- Higher rates and credit contraction make it more expensive for businesses and consumers to borrow money. This can lead to slower economic growth, as businesses may be less likely to invest, and consumers may be less likely to spend.
- The M2 growth rate is a measure of the growth of the money supply. It has been declining rapidly in recent months, in fact the most since the 1930s, which is a sign that the Federal Reserve's (Fed) tightening measures are taking effect. The decline in the M2 growth rate is likely to put downward pressure on the U.S. economy and inflation, with a potentially long and variable lag. This is because there will be less money in circulation to bid up prices.
- An inverted yield curve is often seen as a reliable predictor of a recession. This is because it suggests that investors are expecting interest rates to fall in the future. This can happen when the economy is slowing down, as investors are less willing to take on risk.
- History shows that there have been ten recessions in the United States since 1955, and in all but one case, the yield curve inverted before the recession began. **The average time between the inversion and the start of the recession was 18 months.**
- Additionally, the stock market can experience a significant rally from the date of the inversion to when a recession begins. For example, **the yield curve inverted in 2006, but the stock market rallied for the next two years**. The recession did not begin until December 2007. The yield curve inverted in November 2022, just eight months ago**, this suggests the current market rally could continue for some time.**
- The slowdown in leading economic indicators in the United States, and other mature economies, is a sign that this windchill factor is buffeting economies around the world**.**
- It is vital to monitor the leading economic indicators closely and to be prepared for the possibility of a recession. However, it is also important to remember that the economy is cyclical, and there will be periods of slowdown that do not always lead to a recession.
- Fed tightening cycles have often led to financial crises. When the Fed raises interest rates, it makes it more expensive for businesses and consumers to borrow money. This can lead to a slowdown in economic growth, which can put pressure on businesses and banks.
- In early March, the Fed did not pause its tightening cycle despite the regional banking crisis. This was because the Fed was concerned about inflation, which was rising sharply at the time. The Fed was worried that if it paused, inflation would get out of control.

- The continued pressure on the banks has made banks reluctant to loan money. Banks are worried about their own financial health and are hesitant to make loans in case the economy slows down and they are unable to collect the money.

- The reduction in lending is another windchill factor for the economy. It will make it more difficult for businesses to get the capital they need to grow and for consumers to get the credit they need to buy homes and cars.

- It is too early to say whether the Fed's tightening measures will lead to a financial crisis. However, the factors that are currently in play are certainly concerning.

- Falling commodity prices and moderating wage growth can lead to lower inflation. This is because falling commodity prices can lead to lower prices for goods and services, which can help to offset the rising cost of labor. This can lead to lower inflation.

- Wage growth is moderating. After rising sharply in 2021, wage growth slowed. This should put downward pressure on inflation, as businesses will have less incentive to raise prices if their labor costs do not increase as rapidly. However, it is also possible that moderation in wage growth is a sign of slower economic growth, as businesses may be less willing to raise wages if they are facing weaker demand.

- Increasing layoff announcements can be an indicator of a slowing economy. Layoffs are often a sign that businesses are struggling financially. If businesses are struggling financially, they may be less likely to hire new employees, which can lead to slower economic growth. It will be important to monitor layoff announcements in the coming months to see if they continue to increase. If they do, it could be a sign that the economy is headed for a recession.

- Jobless claims can be a good indicator of a recession, but only if they are consistently high for a period of time. This is because recessions are characterized by a sustained increase in unemployment. Therefore, while the recent increase in jobless claims is a concerning sign, it is too early to say whether we are close to a recession.

- **Even if we do enter a recession, the stock market decline may be muted because the market has been anticipating Fed tightening and a future recession since early 2022. The market has already corrected sharply, and we believe there may not be much more downside left. However, it is important to remember that the stock market is unpredictable, and there is no guarantee that any decline will be muted.**

- Tax-free municipal bonds and taxable corporate bonds can still be competitive alternatives to stocks. For example, a 3.5% tax-free yield on an 8- to 10-year municipal bond is equivalent to a 6% annual return on stocks for a California resident, at current capital gains rates. This is because California residents pay state income taxes on their stock earnings, but not on the interest payments from municipal bonds.

- **It is important to own individual bonds, not bond funds or bond ETFs. Individual bonds** are a **true "fixed income" investment** because they have a **stated coupon and maturity or call date** that **guarantee a return** if held to their maturity or call date. **Bond funds and bond ETFs** are **not true "fixed income" investments** because they do not guarantee a return. They are **risk assets**, similar to **high dividend paying stocks**, and **should not be part of your fixed income asset allocation**.

Important. Fraud and cybercrime are serious threats and are becoming increasingly sophisticated, so constant vigilance is key. Our firm plays an important role in helping safeguard your assets, but you need to take action yourself to protect and help secure your information.

Safe practices for your personal money and communicating with our firm:

- **Keep us informed** regarding changes to your personal information.
- **Expect us to call you to confirm email requests** to trade, move money, or change account information.
- **Be suspicious** of unexpected or unsolicited phone calls, emails, and texts asking you to send money or disclose personal information. If you receive a suspicious call, hang up, then call them back, using a known contact number.
- **Be cautious when receiving money movement instructions via email.** Call the sender at their known number (not a number provided in the email) to verbally validate all instruction details before following instructions or providing your approval.
- **Verify payment requests you receive by phone or email.** Requests for payment using gift cards, prepaid debit cards, or digital currency are frequently associated with fraud or scams.
- **Be cautious when sharing sensitive information** and conducting personal or confidential business via email because it can be compromised and used to facilitate identity theft.
- **Do not disclose on social media sites personal or sensitive information**, such as your birth date, contact information, and mother's maiden name.
- **Protect yourself from phishing attempts**, do not click on suspicious links.
- **Check your email and account statements regularly for suspicious activity**.
- **Do not verbally disclose or enter confidential information** on a laptop or mobile device in public areas where someone could potentially see, hear, or access your information.

Winston Churchill said, "Fear is a reaction. Courage is a decision." We know that it can be difficult to stay calm when the market is volatile, and not react out of fear. Investors should make decisions based on their long-term goals and risk tolerance, and not let short-term market fluctuations dictate their investment strategy. We believe investors should stay the course, remain invested in high quality equities for now. Additionally, tax-free municipal bonds and taxable corporate bonds are competitive alternatives to stocks.

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

Jay Kellett

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- All graphs were produced by KCM using data from Bloomberg. Bloomberg is also the source of the stated economic data.