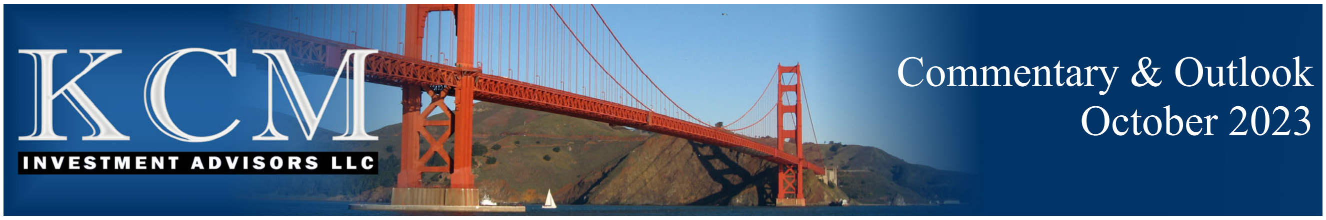


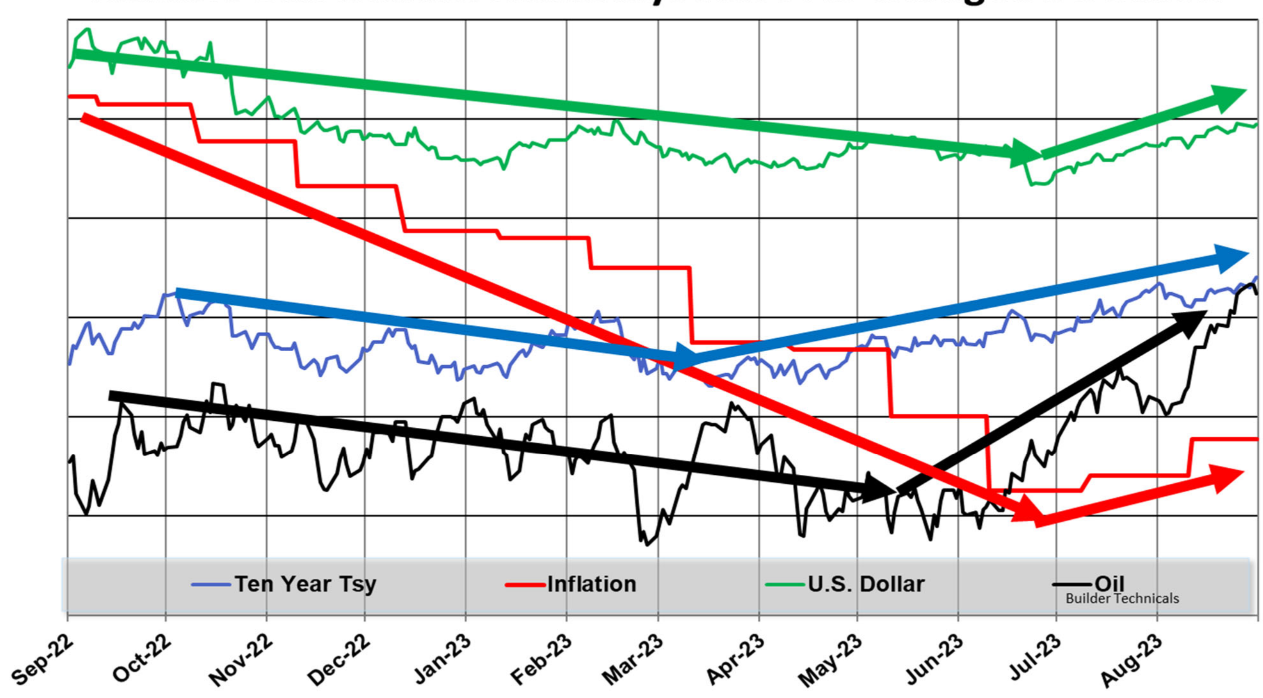
Bonds: Our Best Idea For Uncertain Times

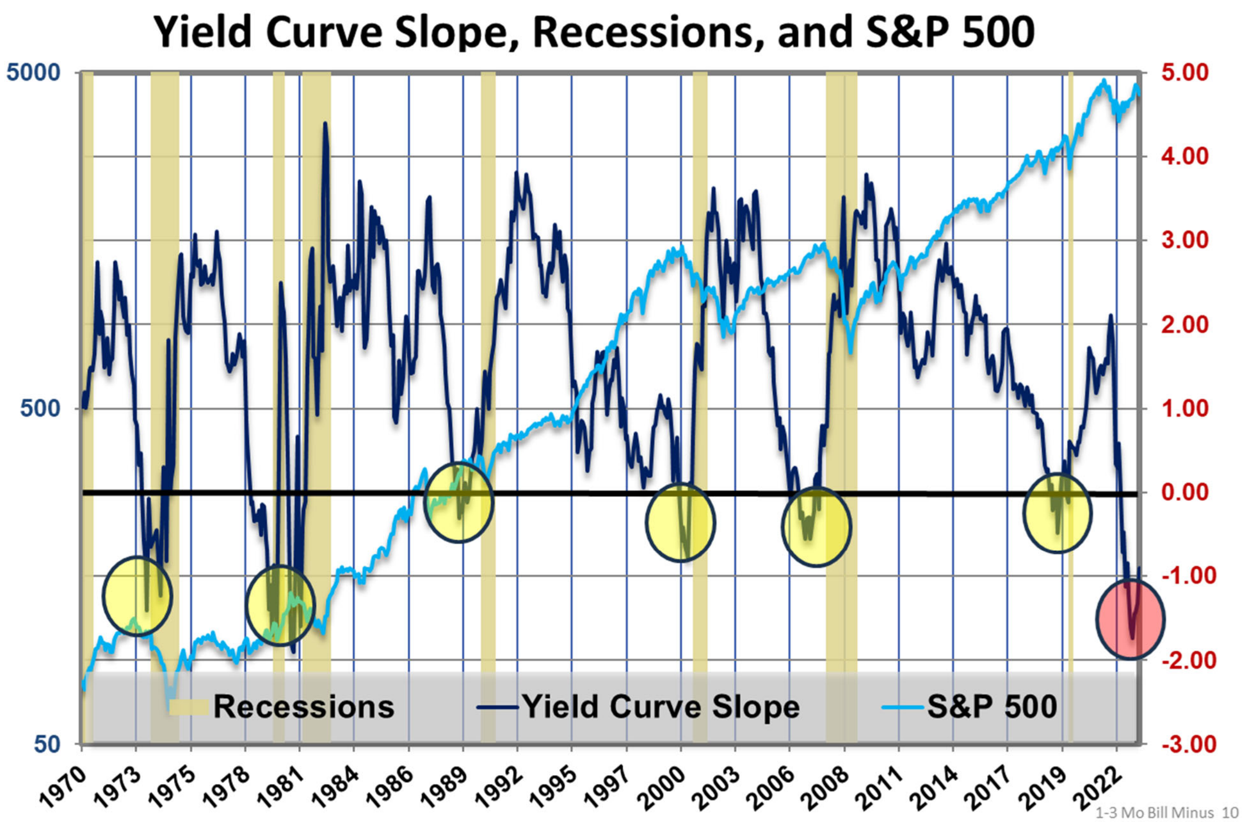
Several reliable bull market mainstays sustained a stock market run-up that extended from the end of third-quarter 2022 through second-quarter 2023. Starting with sharply declining inflation, the Consumer Price Index (CPI) plummeted from an 8% to about a 3% annualized rate at the end of June. Ten-year Treasury bond yields peaked at about 4.25% and were diminishing, reaching about a 3.3% low. The dollar index was also weakening, dropping from about 114 to 100 by mid-July. A weak dollar benefits corporate earnings, as it makes U.S.-manufactured goods more affordable to our trading partners. Importantly, oil prices were relatively stable and, in general, falling.

But in recent months inflation, measured by the CPI, moved up slightly to about 3.65%, year over year. Ten-year treasury bond yields bottomed out at about 3.3% and have since risen to 4.6% (<u>creating an attractive buying opportunity for investors seeking income and diversification</u>). The dollar index has moved up to about 106. Perhaps most worrisome is the sharp upward reversal in oil prices: WTI crude oil prices bottomed out at about $67/barrel in June and are now about $91/barrel.

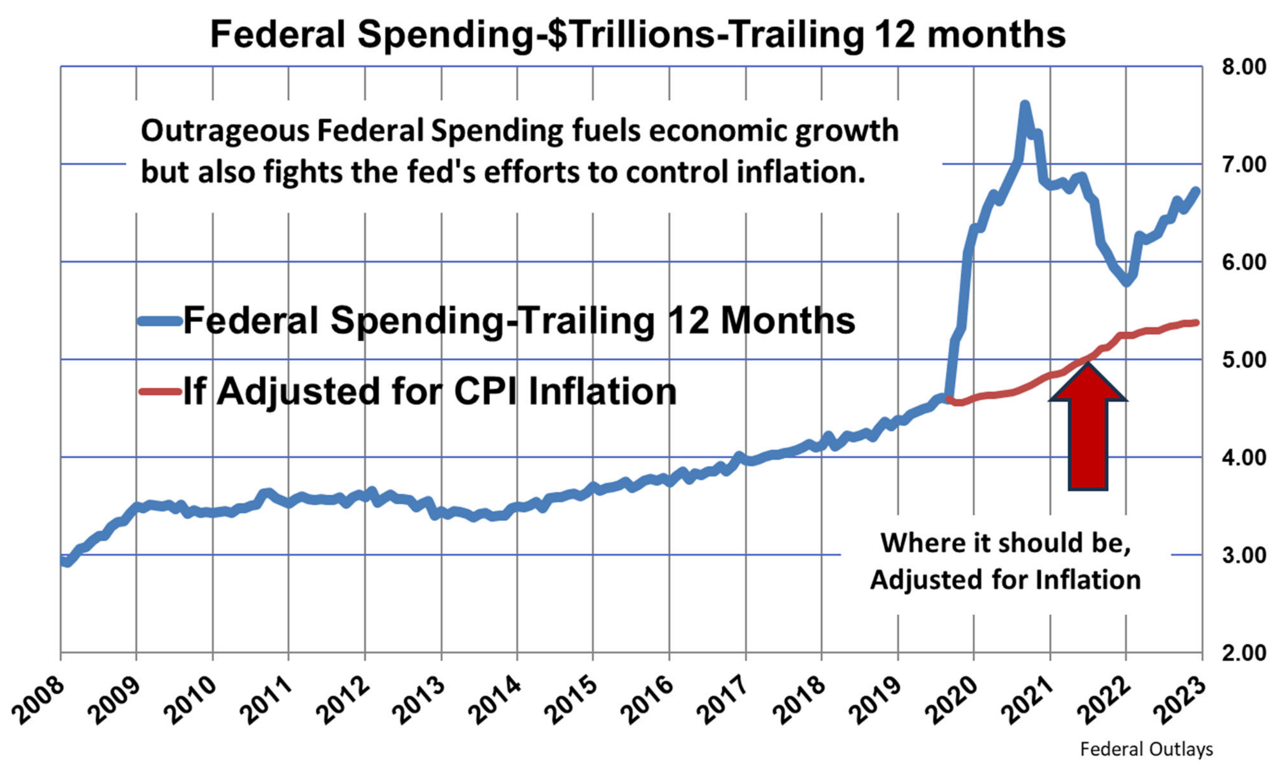
For investors who are confused by the many mixed signals for where the economy is heading, we would offer that it is difficult to sustain a stock market rally when four important pillars of the rally have reversed direction.

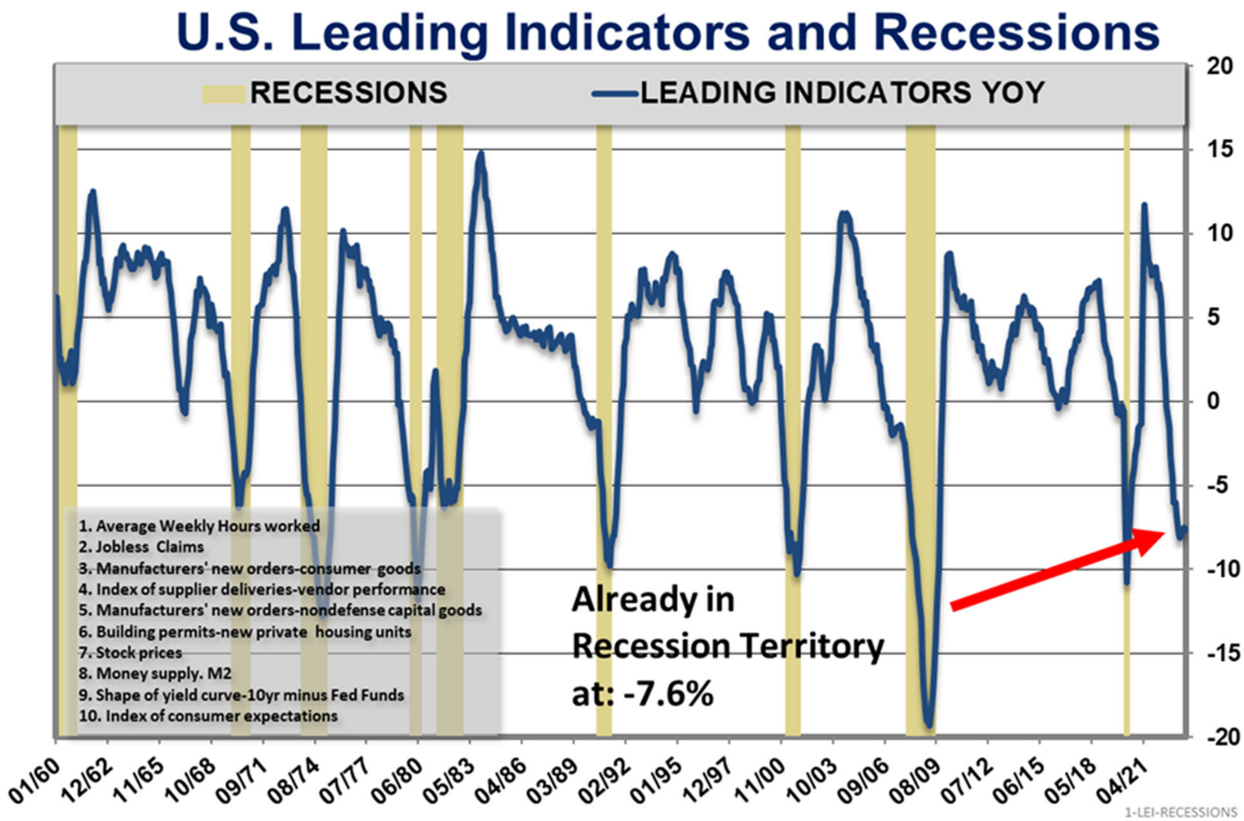
Reliable Bull Market Mainstays Have All Changed Direction





Uncertain times: While inflationary federal outlays may postpone a recession for a while (see exhibit below), history tells us, with 100% certainty going back to 1970, that one is on the horizon (see exhibit above).





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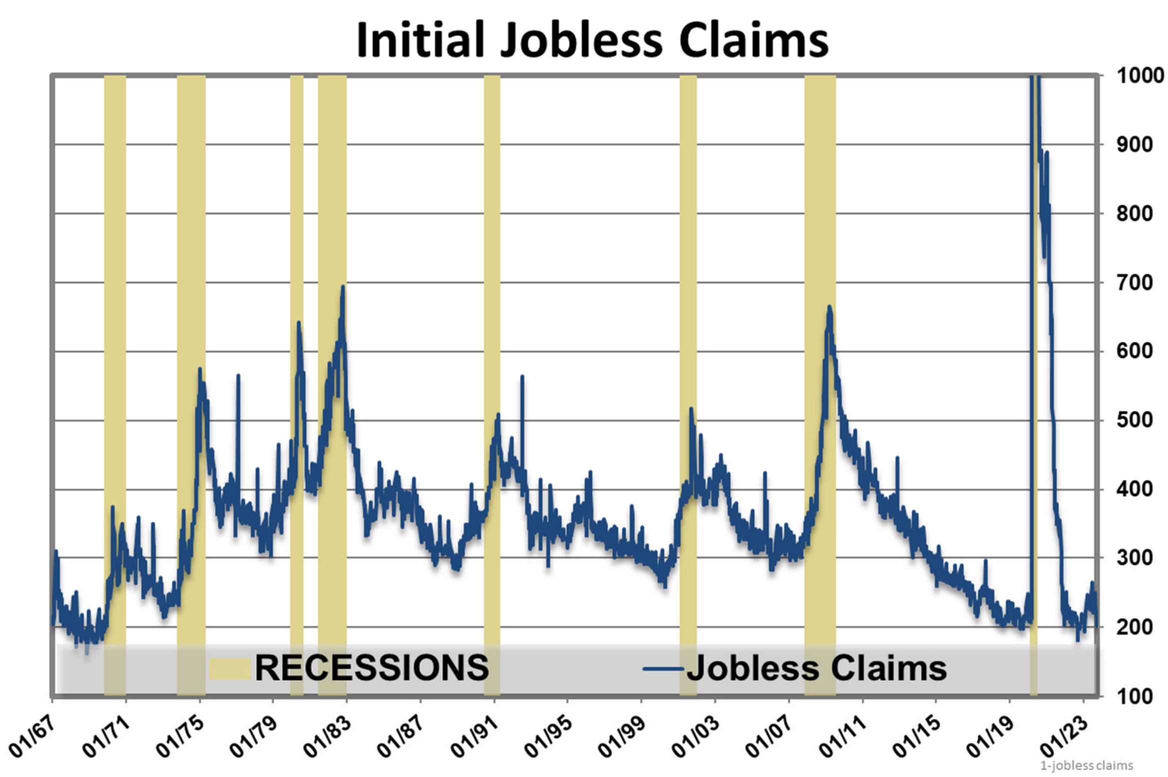
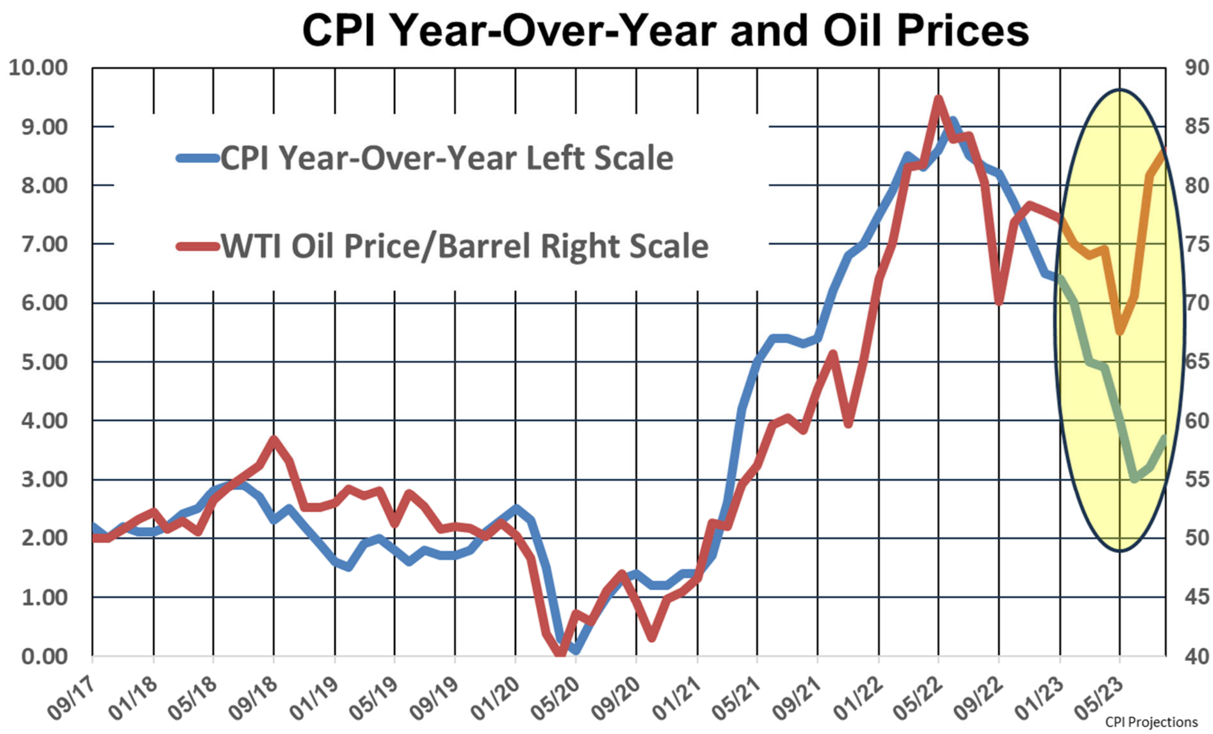
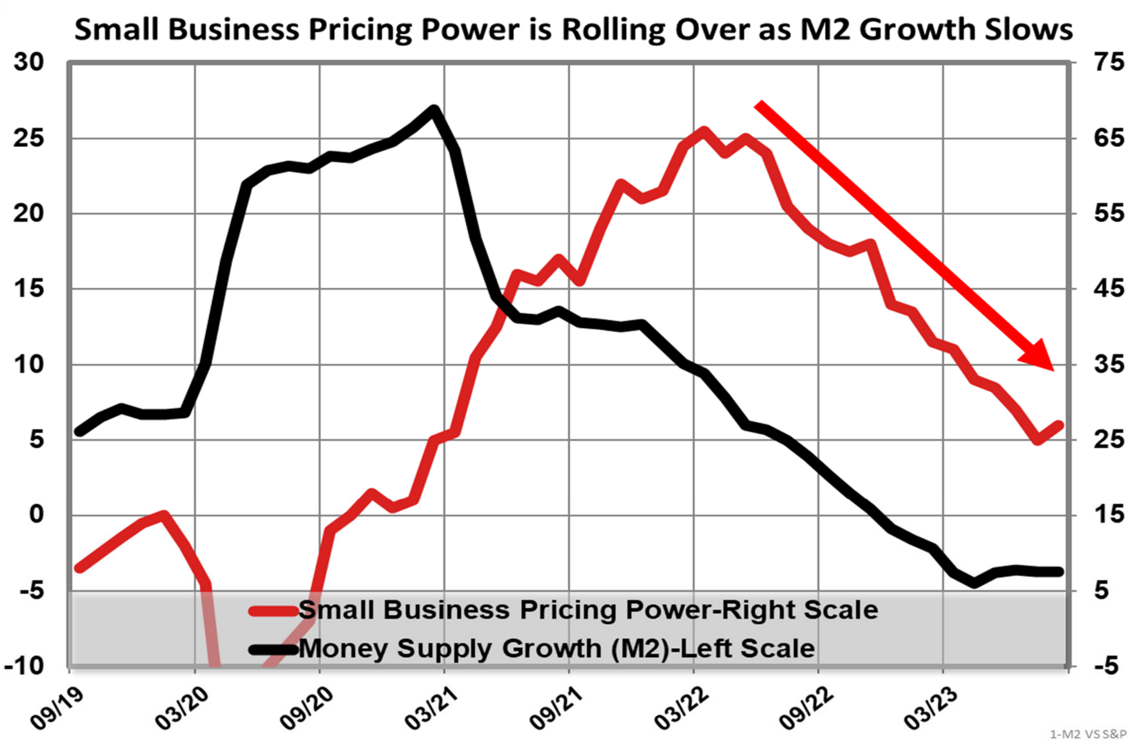
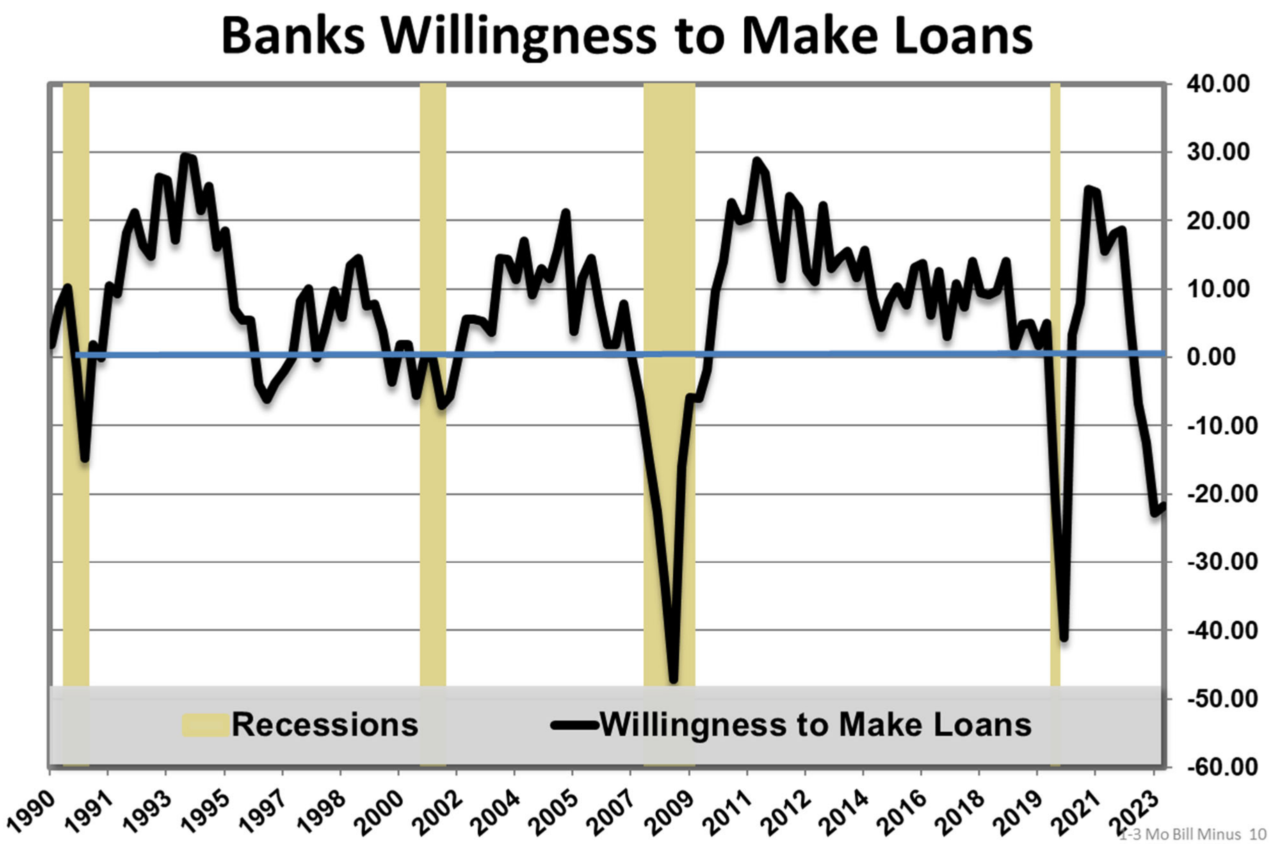
Uncertain times: Historically, low jobless claims suggest a booming economy (see exhibit above), but U.S. leading indicators signal a recession (see exhibit below).



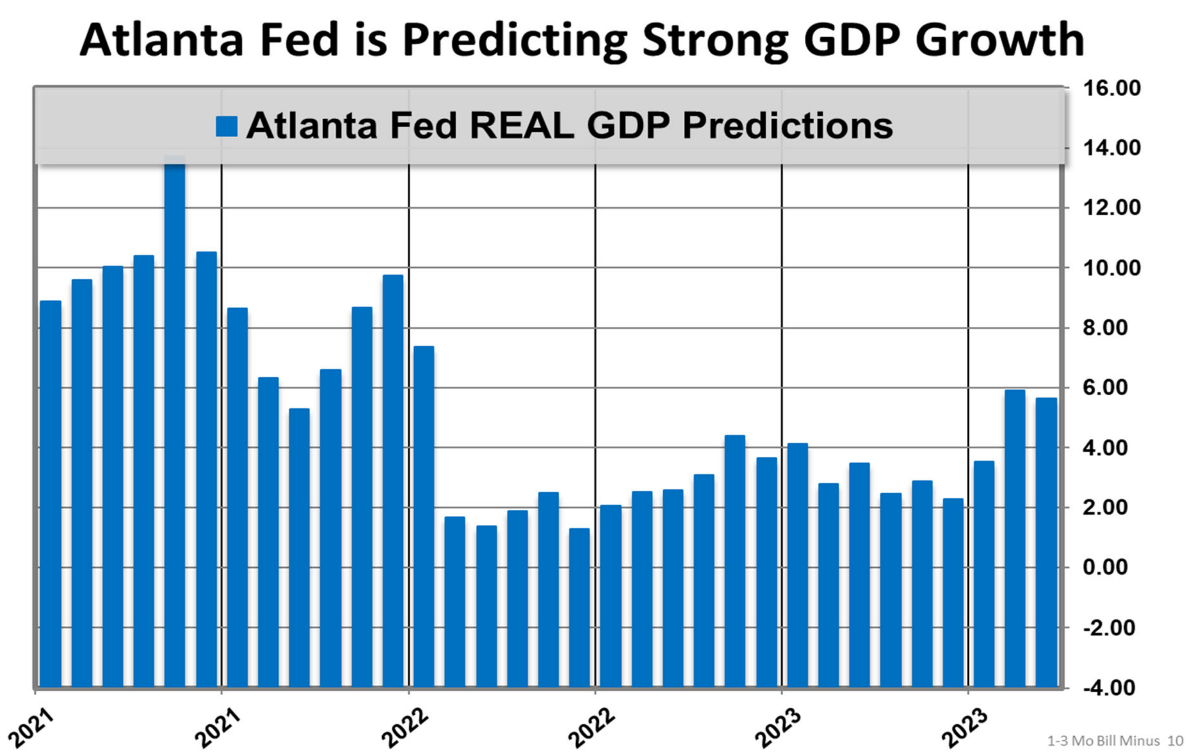


Uncertain Times: Oil prices and inflation correlate well. Rising oil prices can boost prices for goods and services, which can lead to inflation (see exhibit above). But when small businesses have less pricing power, they are more likely to reduce prices to compete. This can lead to a general price drop, which is deflation (see exhibit below).





Uncertain Times: The Atlanta Fed still predicts nearly 5% real GDP growth (see exhibit below), but we note that following the regional bank crisis, banks are significantly less willing to make loans, putting a damper on growth (see exhibit above).



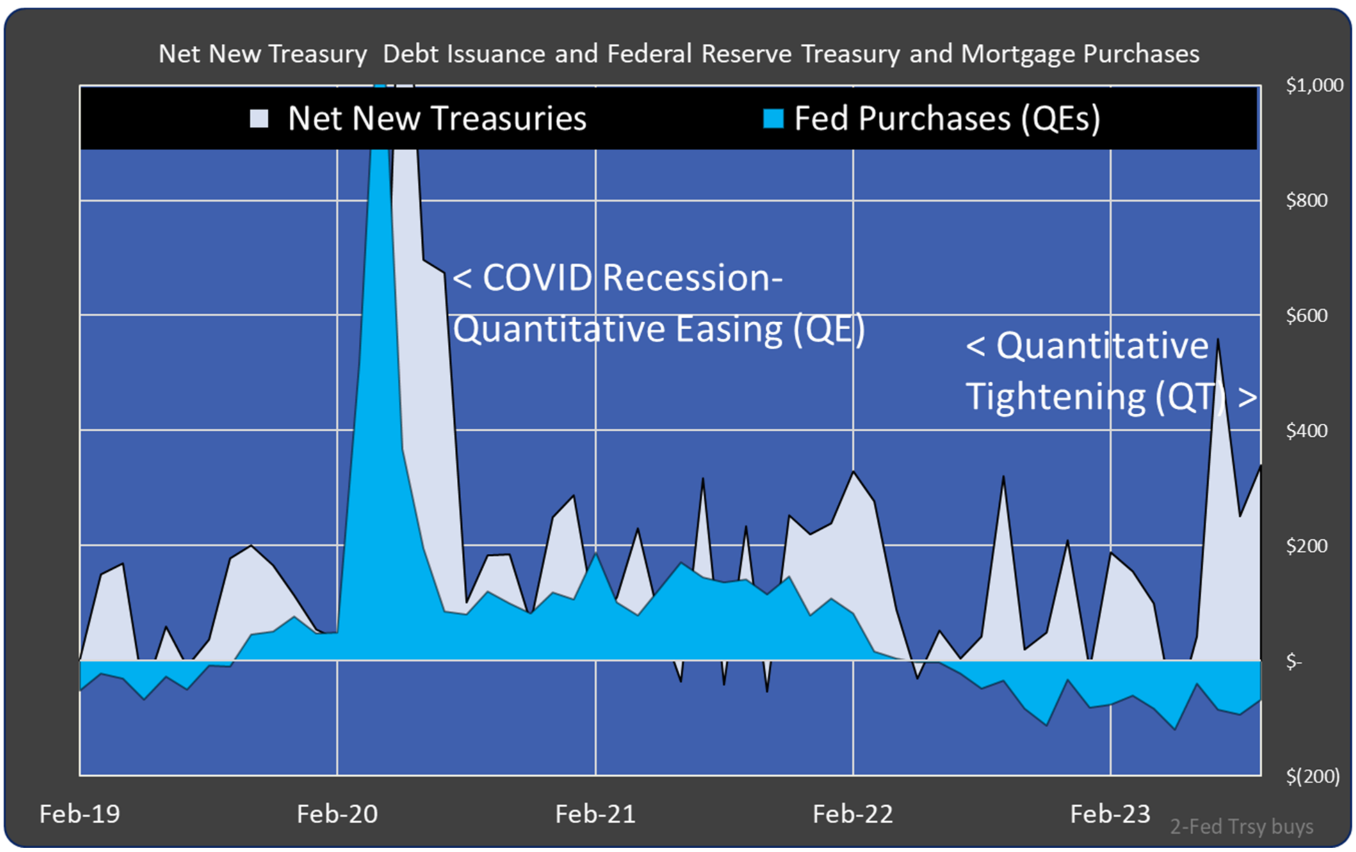
Our Best Idea: Bolster Portfolios With Attractively Priced, Carefully Selected Bonds

Bonds offer a certain return and can be a wise investment in uncertain times. Bonds are typically less volatile than stocks, and they can provide a guaranteed return, and a steady stream of income. However, it is important to choose the right type of bonds for your investment goals and risk tolerance.

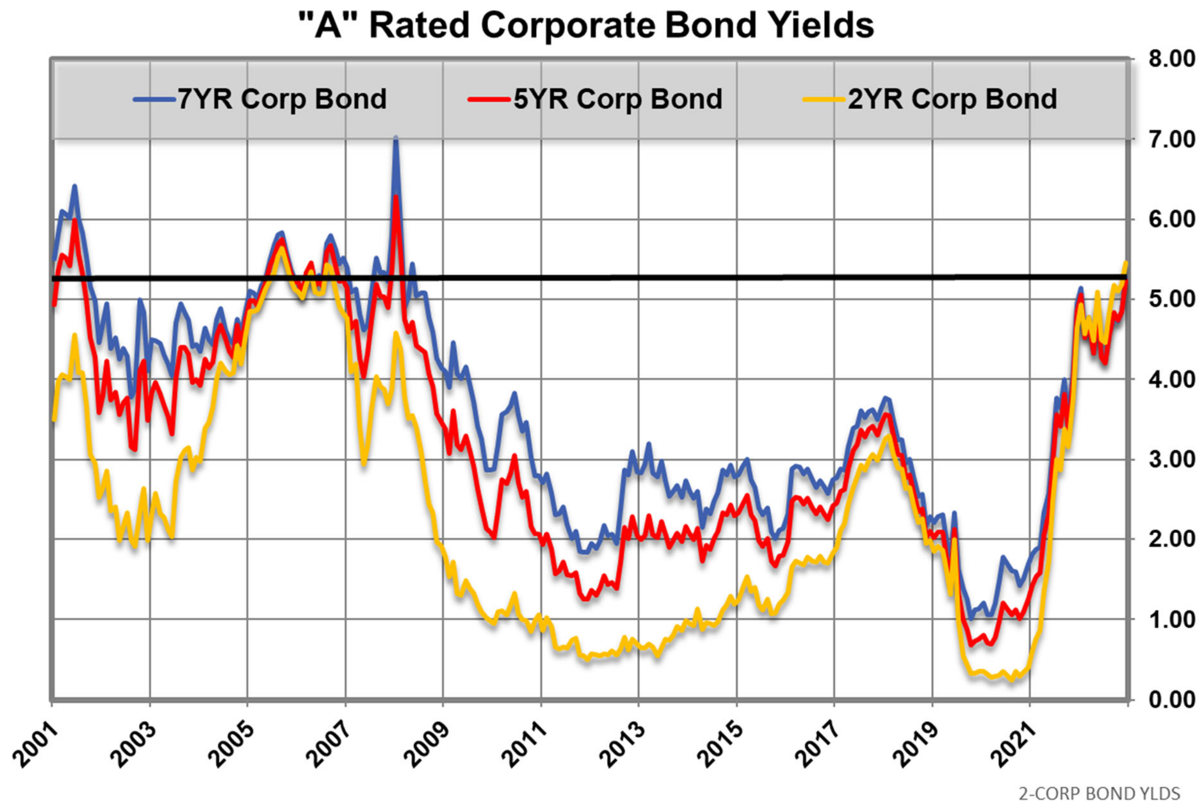
- Treasury bonds are issued by the US government, and they are considered to be very safe investments. However, they typically offer lower yields than corporate bonds.

- Corporate bonds are issued by companies, and they can offer a higher yield than Treasury bonds, but they also carry more risk. They are also subject to federal and state income tax, but they may be a good option for investors in tax-free accounts, such as IRAs, and 401(k)s.

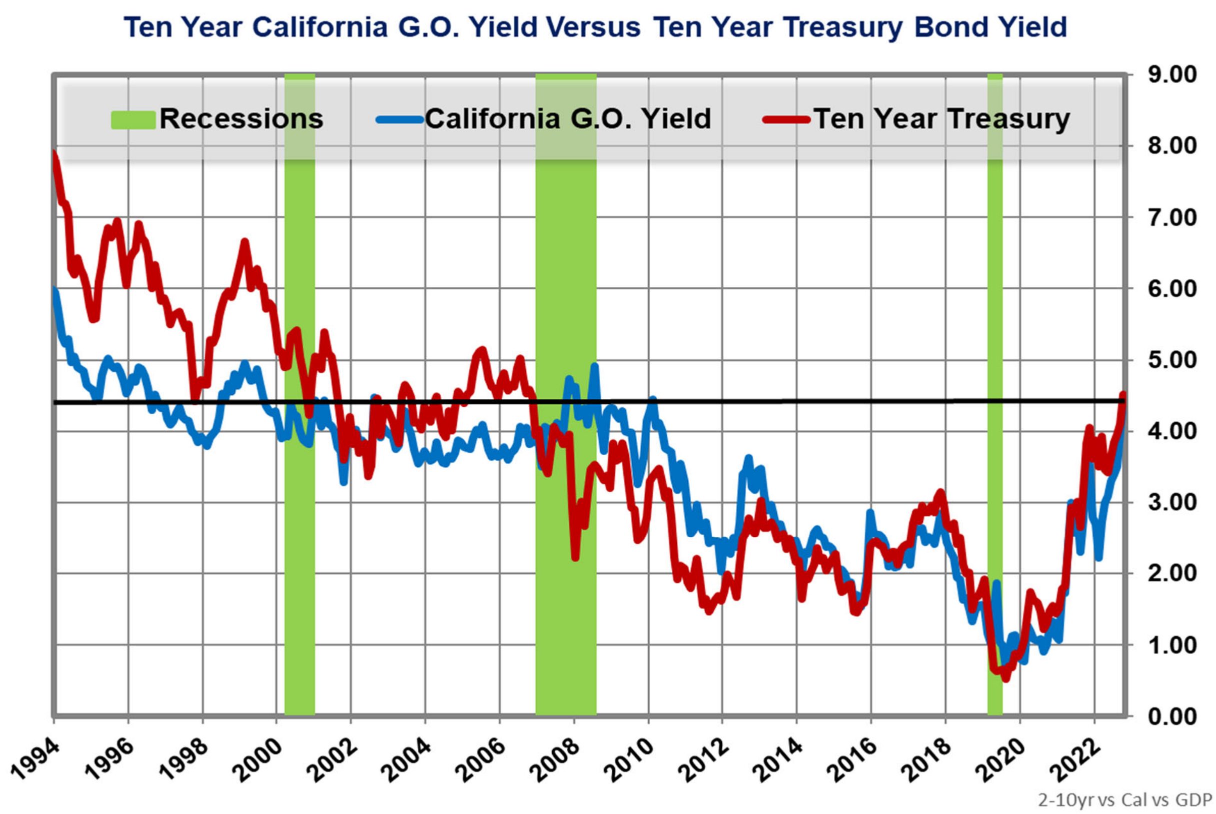
- Tax-free municipal bonds are issued by state and local governments, and they are exempt from federal income tax. For investors in high tax brackets, especially those living in high-tax states, municipal bonds can offer the best after-tax return.

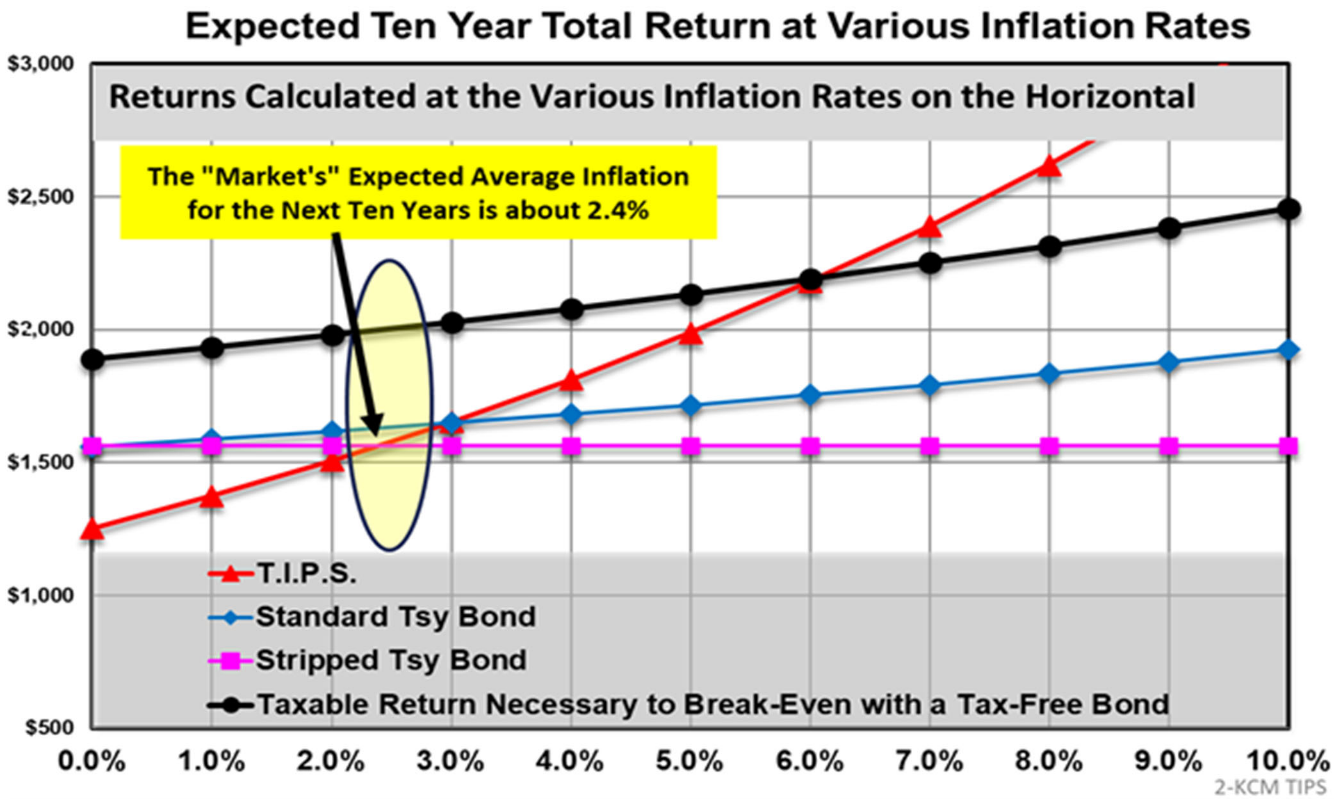


Massive Treasury debt issuance (see exhibit above), combined with the Fed's quantitative tightening (QT), has put upward pressure on bond yields. QT is the Fed's process of selling assets from its balance sheet and not reinvesting the proceeds from maturing assets into new Treasury issuance.

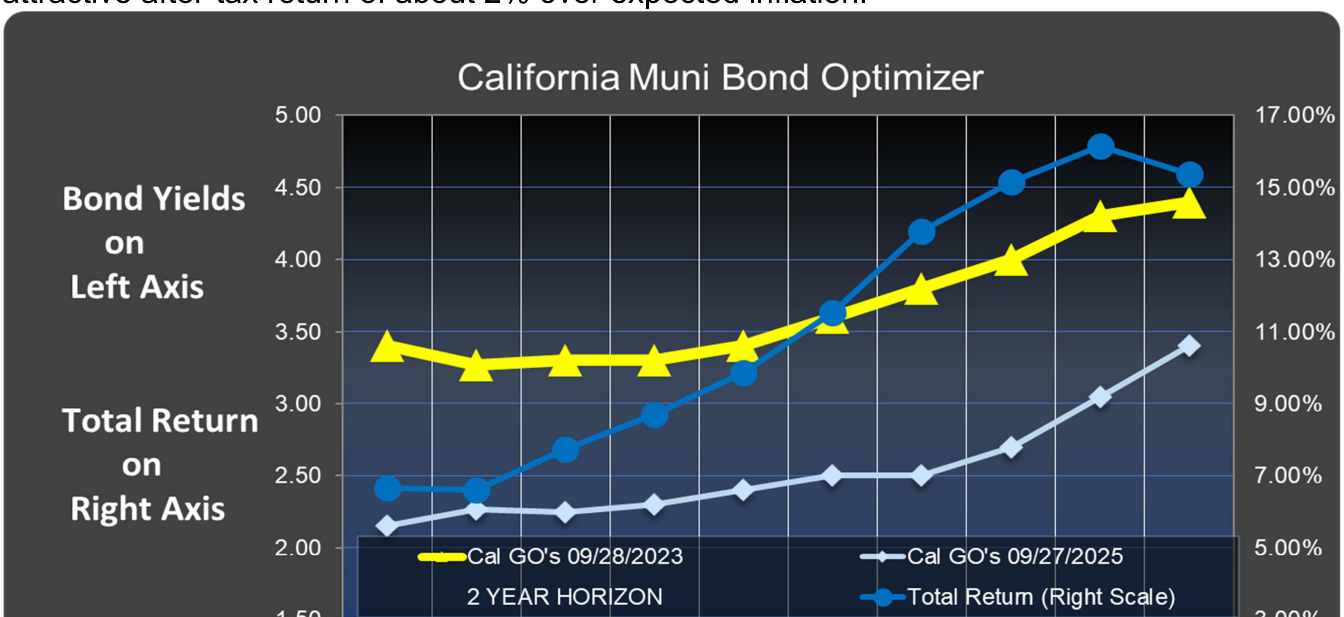


The last time corporate bond yields were at today's level was 2007 (see exhibit above), the same year we saw Treasury bond and municipal bond yields as high as today (see below).





The market expects about 2.40% annual inflation rates for the next ten years (see exhibit above). Ten-year municipal bonds yield about 4.40% (see exhibit below), giving investors an attractive after-tax return of about 2% over expected inflation.



	1	2	3	4	5	6	7	8	9	10
Cal GO's 09/28/2023	3.40	3.27	3.30	3.30	3.40	3.60	3.80	4.00	4.30	4.40
Cal GO's 09/27/2025	2.15	2.27	2.25	2.30	2.40	2.50	2.50	2.70	3.05	3.40
2 YEAR HORIZON										
Total Return (Right Scale)	6.67%	6.60%	7.74%	8.70%	9.87%	11.53%	13.79%	15.15%	16.16%	15.38%

Wrapping up:

Several reliable bull market mainstays sustained the stock market run-up that extended from the end of third-quarter 2022 through second-quarter 2023. Starting with sharply declining inflation, the CPI plummeted from an 8% to about a 3% annualized rate at the end of June. Ten-year Treasury bond yields had peaked at about 4.25% and were diminishing, reaching about a 3.3% low. The dollar index was also weakening, dropping from about 114 to 100 by mid-July. A weak dollar is a plus for corporate earnings, as it makes U.S.-manufactured goods more affordable to our trading partners. Importantly, oil prices were relatively stable and, in general, falling.

These pillars of a bull market are important because they create a favorable environment for businesses and investors. Here is why:

- Declining inflation: Inflation can erode corporate profits and consumer purchasing power, so declining inflation is a positive for the economy and the stock market.
- Falling interest rates: Lower interest rates make it cheaper for businesses to borrow money and invest. They also make it more attractive for investors to buy stocks and other risk assets.
- A weak dollar: A weak dollar makes U.S. exports more competitive and imports more expensive, which can boost U.S. corporate profits and economic growth.
- Declining oil prices: Oil is a major input cost for consumers and most businesses, so falling oil prices can increase consumers' discretionary spending and reduce costs.

When all of these mainstays' reverse direction, it can create a number of challenges for businesses and investors. For example, rising inflation can erode corporate profits and consumer purchasing power, rising interest rates can make it more expensive for businesses to borrow money and invest, and a strong dollar can make US exports less competitive and imports cheaper. This can lead to slower economic growth and lower corporate profits, which can hurt stock prices.

The recent sharp increase in oil prices is worrisome and is likely to put upward pressure on inflation. Higher oil prices are immediately passed through to gas, diesel, and jet fuel prices, which in turn boost grocery prices and discourage consumer spending on restaurants and travel. Higher costs may lead workers to push for higher wages, potentially creating a wage-price spiral and stagflation. Higher oil prices could also lead the Fed to keep interest rates higher or even raise them, making borrowing more costly for businesses and consumers, slowing economic growth, and also hurting stock prices.

History screams, with 100% certainty back to 1970, that a recession is on the horizon.

Inflationary federal outlays may postpone a recession, stimulating the economy by boosting demand for goods and services. This can enhance economic growth, reduce unemployment, and lift wages and stock prices. But they can also lead to higher inflation and interest rates, as government spending essentially fights the Federal Reserve's efforts to reduce inflation by raising interest rates and taking money out of the system. This could force the Fed to raise interest rates and decrease the size of its balance sheet more than it might like. Ultimately, whether federal outlays can postpone an inevitable recession is a matter of debate.

There is no guarantee that they will be successful, although they may be able to delay a recession for some time, perhaps until after the 2024 election. What is important to note is that over-the-top federal outlays incur risk. If the government borrows too much money to finance these outlays, a financial crisis may occur. Moreover, if the economy does enter a recession, it could be more severe because the Fed was forced to raise interest rates higher than otherwise needed.

Other potentially bad news.

A government shutdown would slow economic growth and could lead to job losses. A prolonged UAW strike would disrupt the automotive industry, probably eliminating jobs. Student loan repayments could also weigh on consumer spending. An appreciating dollar would make U.S. goods and services more expensive for foreign buyers, which could reduce exports. And higher oil prices would increase the cost of energy and transportation, which could also lead to inflation.

An over-the-top UAW wage and benefit increase, along with a shorter work week, would increase the cost of labor for automakers. Automakers would then likely pass the higher costs on to consumers in the form of higher prices for cars and trucks. This would increase demand-pull inflation and may lead to stagflation. The latter, last experienced in the U.S. in the 1970s, is a particularly dangerous economic phenomenon because it is difficult to combat, often being impervious to monetary and fiscal policy tools. Thus, stagflation can lead to a prolonged period of economic stagnation and hardship.

We say bonds are the way to go in such uncertain times.

U.S. leading indicators signal a recession, while, on the other hand, historically low jobless claims suggest a booming economy. How can investors cope with all this uncertainty?

Our best investment idea in these uncertain times is to take advantage of bond yields that we last saw 15 years ago by adding attractively priced taxable and tax-free bonds to their portfolios. Bonds are typically less volatile than stocks, offer a guaranteed return and are currently competitive with historical equity returns. Market expectations for inflation over the next ten years are about 2.40% annually. Ten-year municipal bonds yield about 4.40%, giving investors an attractive after-tax return of about 2% over expected inflation.

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
Founder and CEO

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

Fraud Prevention

As you know, protecting your assets and data is priority number one for our firm. But it's also important that you know about threats you may encounter in other interactions online—from your personal email account to social media to dating apps. In each of these channels, you may run into scams specifically designed to steal your information or assets. By reviewing this information, maintaining best practices, and exercising caution in your online activities, we can work together to keep your assets safe.

Scam Awareness - Common Types of Scams

Romance/Marriage

Scammer asks for money after establishing an intimate/ emotional online relationship

Sweepstakes/Lottery

Scammer promises your winnings after you send them payment for fees/taxes

Government Impersonators

Scammer poses as government official to intimate you into paying a fine or penalty

Investment

Scammer convinces you they have an investment opportunity and asks you to use a wire transfer or cryptocurrency

Tech or Fraud Support

Scammer pretends to be from a reputable tech company to gain financial information or remote access to your device

Email Compromise

Scammer sends a message that appears to come from a known source, asking for money or information

Remember: if you are ever suspicious of any situation like the ones discussed above, please call us. We are eager to help you, especially when it comes to your security.

If you suspect a scam or if you're the victim of a scam, immediately contact our firm at 415-461-7788 or Schwab Alliance at 800-515-2157

Best Practices

- **Keep us informed** regarding changes to your personal 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.