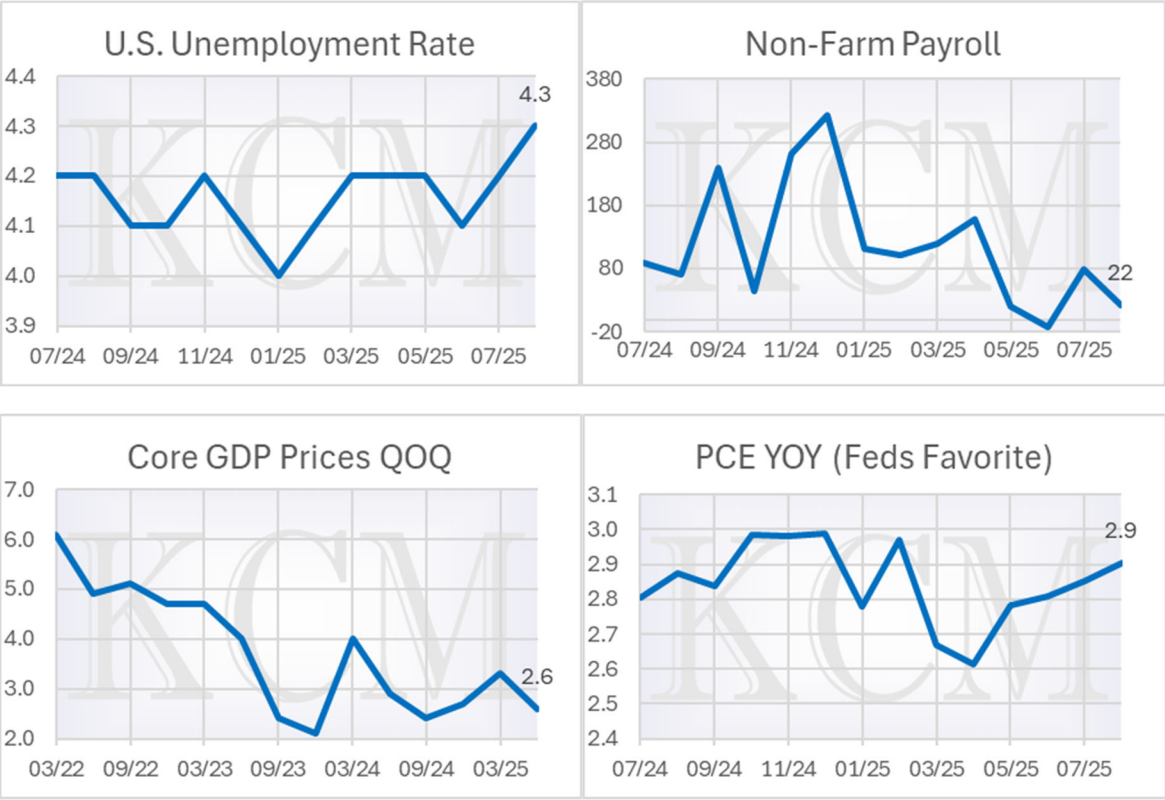
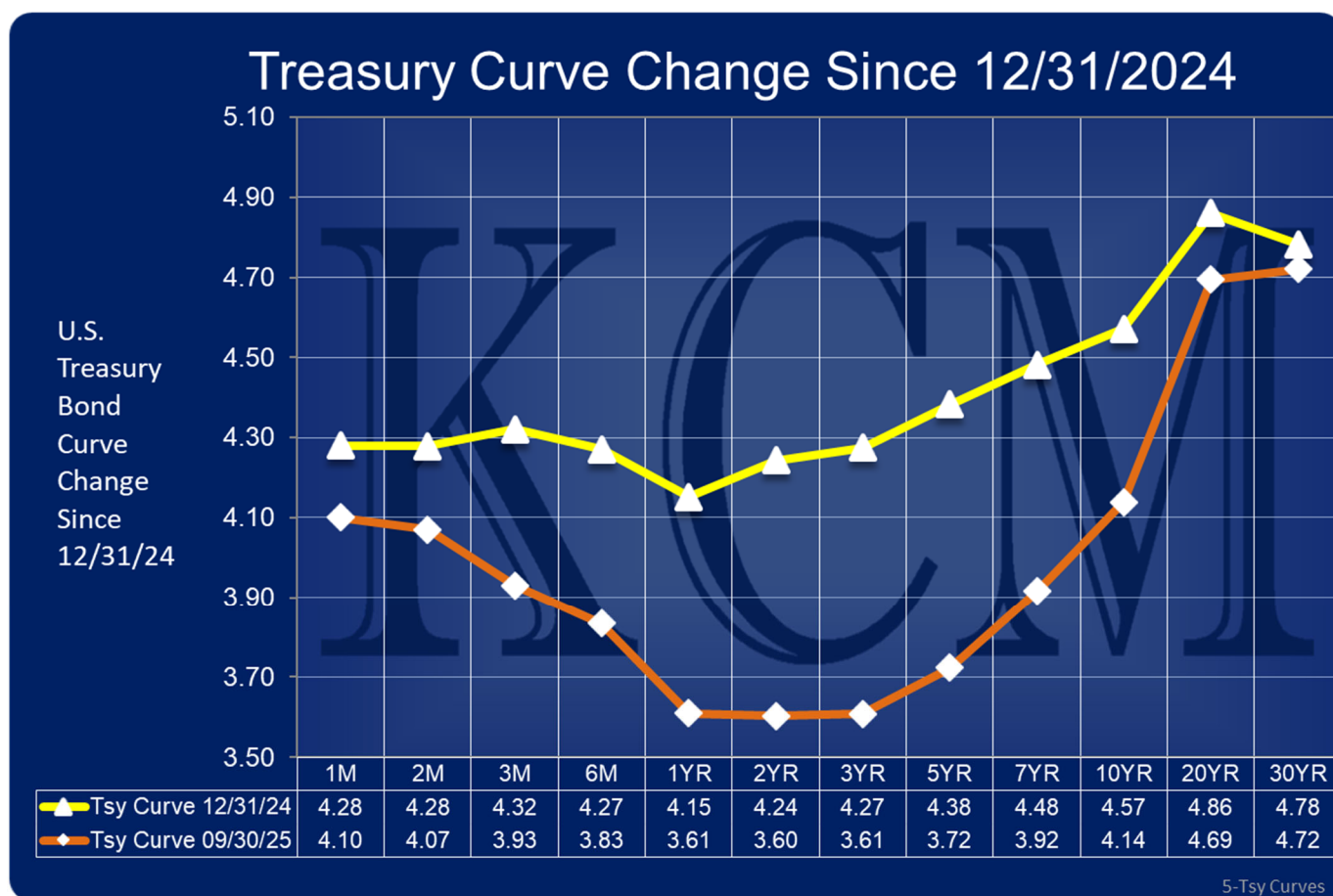


A Complex But Compelling Time For Investors

The current macroeconomic environment presents a compelling and complex picture for investors heading into the final quarter of 2025. A confluence of factors has given rise to a potential "Goldilocks" scenario. Chief among these are a newly dovish Federal Reserve, which lowered the Fed Funds rate by 25 basis points to 4.00%-4.25% on September 17th due to a softening and significantly downward-revised non-farm payroll numbers as well as a rising unemployment rate, alongside mixed but generally acceptable inflation, illustrated by the Core Gross Domestic Product Price Deflator (GDP) and U.S. Personal Consumption Expenditures Core Price Deflator (PCE) (charts below). This scenario describes an economy that is not too hot to fuel runaway inflation, nor too cold to trigger a recession, fostering a positive outlook for the U.S. economy and stock market.

The Federal Reserve's recent rate cut, with two more anticipated by year-end, fundamentally alters valuation paradigms for equities and provides a supportive backdrop for fixed income. While longer-term bond yields remain stubbornly range-bound, suggesting the market does not foresee a dramatic resurgence in long-term growth or inflation, the decline in short-term rates has profound implications. The shift from a hawkish, inflation-fighting stance to a more accommodative, pro-growth posture has reshaped the investment landscape.



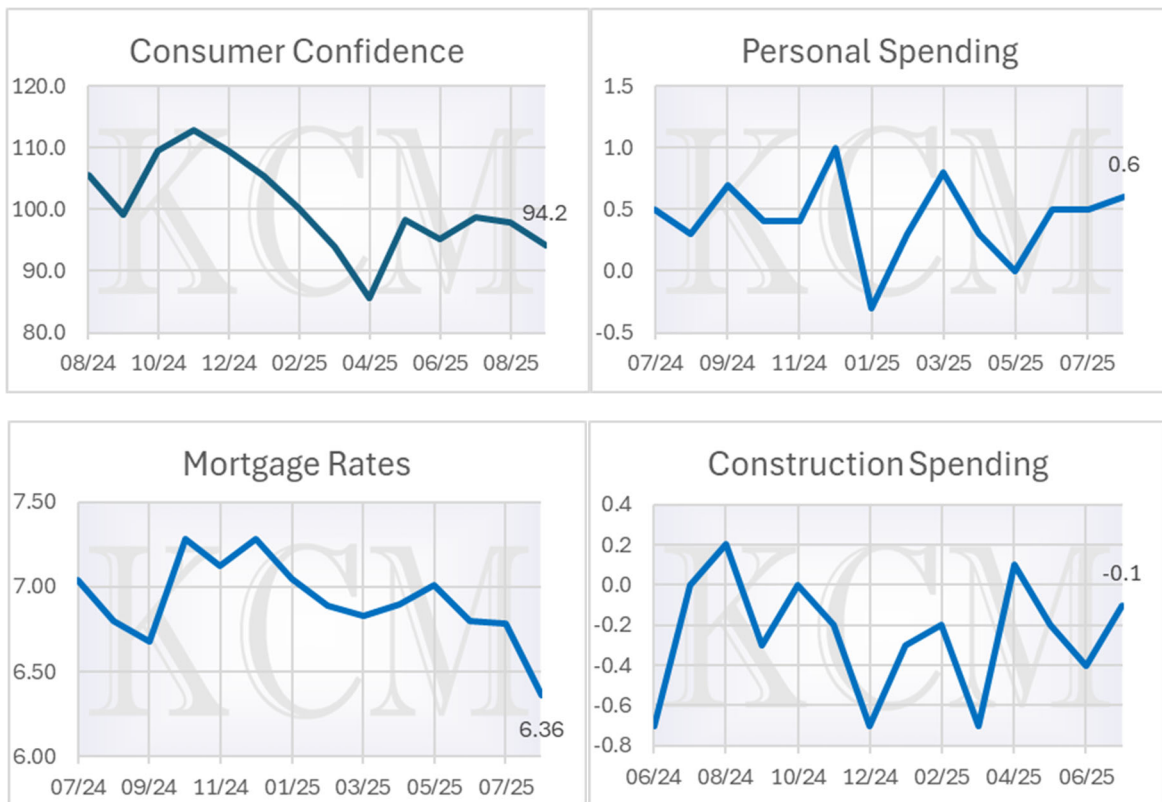


The Crucial Role of Declining Interest Rates in Bolstering the Stock Market, Housing Market, and the US Economy

The interplay between short-term interest rates, such as the federal funds rate, and longer-term treasury bond yields is a critical determinant of the health and trajectory of the stock market, housing market, and the broader US economy. A decline in short-term rates synchronized with stable or falling long-term rates generally signals a more accommodative monetary environment. This dynamic supports the argument for a stable, enduring economic expansion rather than a volatile boom-bust cycle, which can provide significant impetus to economic activity and asset valuations.

Reduced Borrowing Costs for Corporations: When interest rates decline, the cost of borrowing for businesses decreases. This makes it cheaper for companies to finance operations, undertake new investments like AI centers and cloud infrastructure, pursue acquisitions, and expand, leading to increased productivity and potentially higher future earnings. Increased profitability and growth prospects tend to boost stock prices.

Lower Discount Rates: In valuation models, future corporate cash flows are discounted back to their present value. When interest rates are lower, the discount rate used in these calculations decreases, resulting in a higher present value of future earnings. This can lead to higher stock prices, particularly for growth stocks that derive more of their value from expected future earnings.



Increased Consumer Spending and Confidence: Lower interest rates translate to reduced borrowing costs for consumers on loans such as mortgages, auto loans, and credit cards. This leaves households with more disposable income, which can stimulate consumer spending. Higher consumer demand, in turn, benefits corporate revenues and profits, supporting stock valuations. Lower interest rates that could lead to a continued robust stock market and an accessible housing market should boost consumer confidence, leading to a virtuous cycle of increased spending and economic activity.

Impact on the Housing Market:

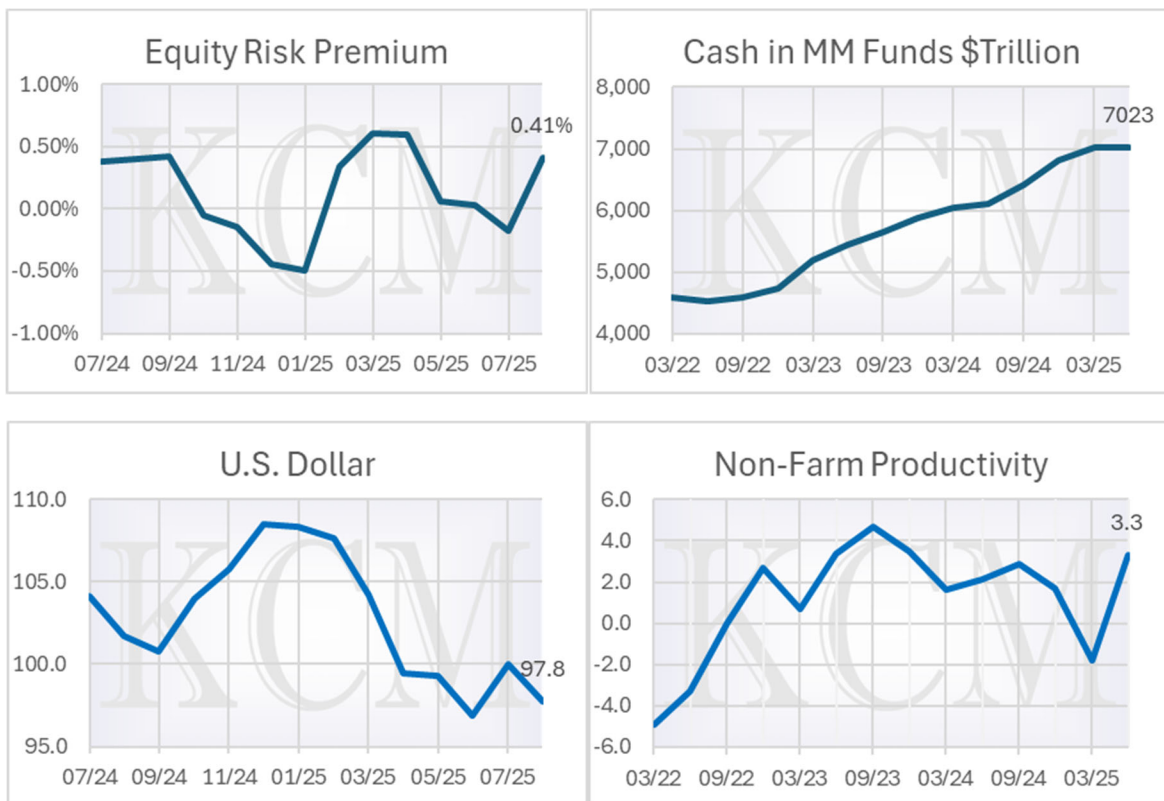
The housing market is particularly sensitive to interest rate movements, especially long-term rates like the 10-year Treasury yield, which heavily influence 30-year fixed mortgage rates.

Enhanced Affordability: A decline in mortgage rates directly reduces the monthly cost of homeownership. This makes housing more affordable for potential buyers, increasing demand and supporting home prices. Conversely, higher mortgage rates can significantly impact affordability, making it harder for American families to purchase homes.

Stimulated Refinancing Activity: Lower interest rates can incentivize existing homeowners to refinance their mortgages at more favorable terms, reducing their monthly payments. This can free up disposable income for other spending or investments, contributing to overall economic activity.

Increased Construction and Development: For developers and builders, lower borrowing costs make it more economical to finance new construction projects. This can lead to an increase in housing supply, which, in conjunction with increased demand, can contribute to a healthy and active housing market.

Shift from Bonds to Equities: A reduction in interest rates makes fixed-income investments like newly issued Treasury bonds and certificates of deposit (CDs) less attractive due to lower yields. This can improve the “Equity Risk Premium” making stocks more attractive and prompt income-oriented investors to reallocate capital from the bond market to the equity market in search of higher returns, further supporting stock prices. Household balance sheets are strong with record levels of cash (\$7 trillion+ in money markets), some poised to rotate into risk assets like stocks as yields on cash instruments fall (top two charts below).



The Weaker Dollar: A Double-Edged Sword

The U.S. dollar has been weakening as a direct result of the Federal Reserve's pivot to lower interest rates. A country's currency tends to fall when its interest rates decline compared to other countries, as international capital seeks higher yields elsewhere. This weaker dollar has distinct effects on corporate profits and consumers. (U.S. Dollar chart above)

A Boon for Multinational Corporations

For U.S.-based multinational corporations that generate a significant portion of their revenue overseas (like major tech and consumer brands), a weak dollar is a powerful tailwind. This is due to a simple translation effect:

When companies earn revenue in foreign currencies (e.g., euros, yen), those revenues must be converted back into U.S. dollars for financial reporting.

When the dollar is weak, each euro or yen converts into more dollars.

This directly inflates the reported revenue and earnings of these companies, even if their underlying business performance in foreign markets is unchanged.

Given that S&P 500 companies derive roughly 40% of their sales from outside the U.S., a weaker dollar provides a significant, automatic boost to aggregate corporate profits.

A Pinch on Consumer Wallets

For the American consumer, the effect is the opposite. A weak dollar reduces their purchasing power for imported goods. Products manufactured abroad, from electronics to clothing to cars, have become more expensive. This can put a mild upward pressure on inflation for certain goods.

However, we believe in the current environment, this effect is likely to be muted. The disinflationary forces from ever evolving supply chains and the AI productivity boom are more powerful than the inflationary impulse from a moderately weaker currency. The net effect remains positive for the economy, as the boost to corporate profits and U.S. competitiveness outweighs the modest drag on consumer purchasing power.

The Immigration and Labor Supply Factor

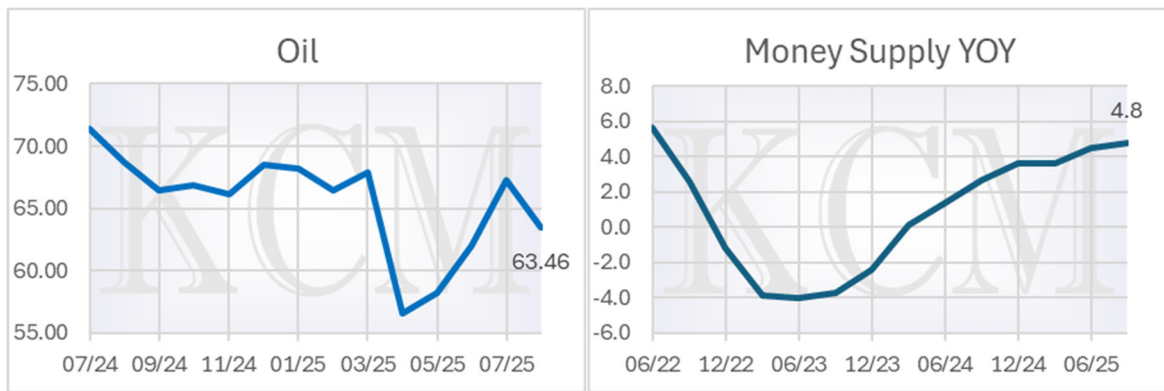
A reduction in the number of new workers entering the U.S. labor market, coupled with an increase in deportations, is constricting the available labor pool, particularly for manual and service-sector jobs. This has two primary effects.

First, with a smaller supply of workers, companies must compete more fiercely for talent. This competition can keep wage growth strong even as overall job growth slows. Second, it is a potential cause of "sticky" inflation, as workers are in a better position to demand wage increases to keep up with the cost of living.

The AI Productivity Boom

The countervailing force to a constrained labor supply is the explosion in productivity driven by Artificial Intelligence (AI). Companies are rapidly adopting AI tools to automate tasks, optimize logistics, enhance customer service, and streamline operations. This allows them to produce more output with fewer labor hours.

This productivity boom has a powerful disinflationary effect. It allows companies to absorb higher wage costs without having to pass them on to consumers in the form of higher prices, thereby protecting their profit margins. The ability of AI to offset labor costs is a cornerstone of the modern Goldilocks narrative and helps explain how we can have low unemployment and moderating inflation simultaneously. (Non-Farm Productivity chart on previous page)



The Oil price graph above shows the price of oil from July 2024 through late 2025. Overall, the trend shows price volatility with a general decline over the period shown. (Oil chart above)

Stable or lower oil prices are generally a positive force for the U.S. economy and help curb inflation. Lower oil prices translate directly into cheaper gasoline and home heating oil. When households spend less on energy, their discretionary income increases. This extra cash can be spent on other goods and services, saved, or invested, all of which boosts economic activity.

For businesses, transportation is a major expense. Cheaper fuel reduces shipping and operating costs for industries like airlines, trucking, and agriculture. This can lead to higher profits, increased investment, and potentially lower prices for consumers.

Lower oil prices are a powerful disinflationary force, meaning they help slow the rate of price increases. The effect is twofold. First, because energy is a direct component of the Consumer Price Index (CPI), falling gas prices immediately pull the headline inflation number down. Second, as businesses' transportation and manufacturing costs decrease, they can pass those savings on to customers. This helps reduce "core" inflation across a wide range of goods and services.

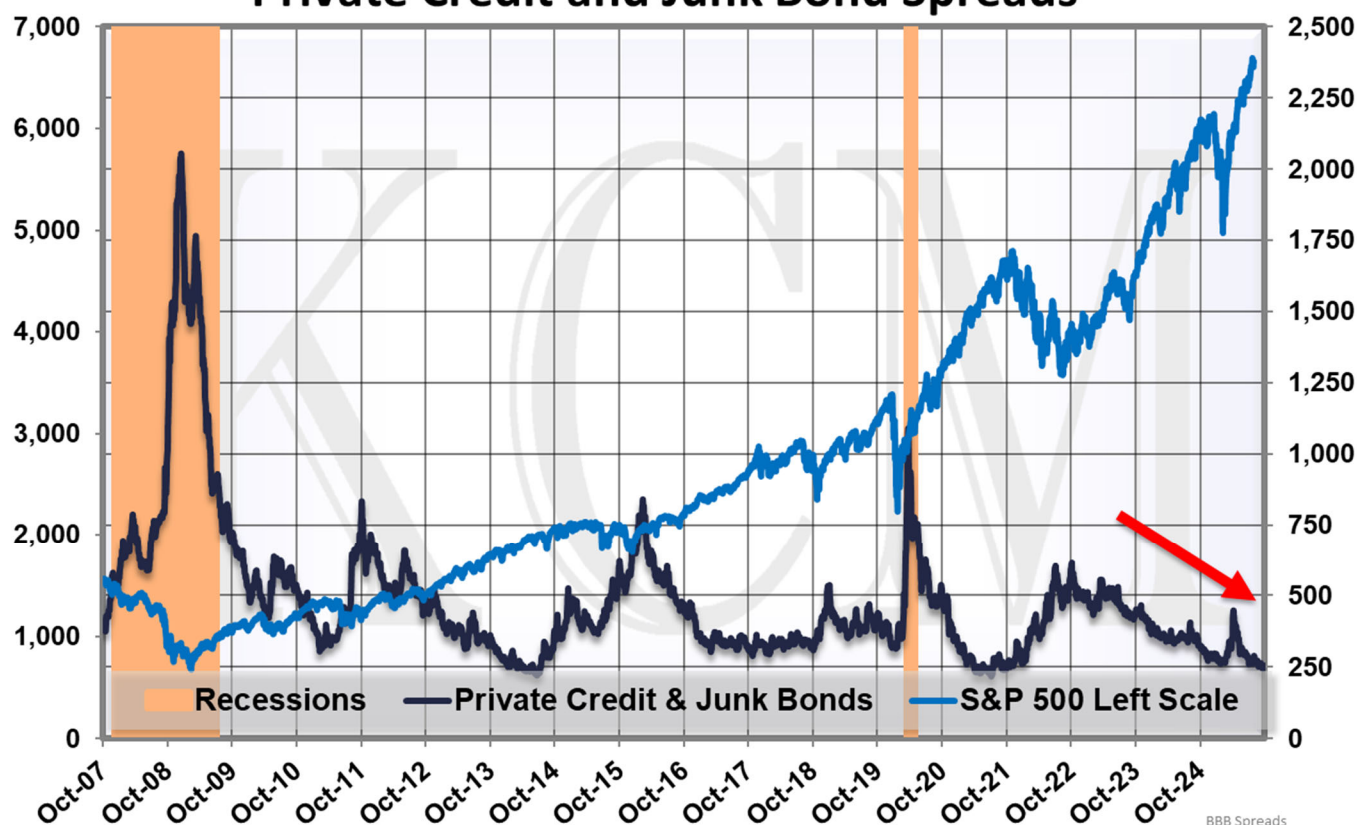
This environment gives the Federal Reserve more flexibility, as there is less pressure to raise interest rates to fight inflation.

The money supply graph (above) shows the year-over-year (YOY) percentage change in the money supply from mid-2022 to mid-2025.

An expanding money supply, like declining interest rates, is also managed by the Federal Reserve, and can have a significant effect on the U.S. economy. The primary goal is typically to stimulate economic activity. When there is more money available in the banking system, the cost of borrowing that money—interest rates—tends to fall. Lower rates on mortgages, car loans, and business loans encourage both consumers and companies to borrow and spend.

In essence, a growing money supply can act like a gas pedal for the economy—it can help accelerate growth but also carries the risk of overheating the U.S. economy and causing inflation.

Private Credit and Junk Bond Spreads



This graph illustrates the relationship between perceived risk in the corporate debt market and the performance of the U.S. stock market.

In short, it shows that when the fear of companies defaulting on their debt is high, the stock market tends to fall, and vice versa.

What the Graph Shows

The chart plots three key pieces of information from late 2007 to late 2024:

Private Credit & Junk Bond Spreads (Dark Blue Line): This line represents the "spread," or the extra yield investors demand to hold risky corporate debt (like junk bonds) instead of ultra-safe government bonds. A higher spread means investors are fearful and demanding more compensation for taking on risk. A lower spread indicates confidence and a low-risk environment.

S&P 500 index (Light Blue Line): This is a benchmark index representing the performance of 500 of the largest U.S. companies. It is a general indicator of the stock market's health.

Recessions (Orange Bars): These shaded areas mark periods of significant economic downturn, notably the 2008 Financial Crisis and the brief 2020 COVID-19 recession.

Main Takeaways

The Private Credit and Junk Bond Spreads graph on the previous page reveals a clear inverse relationship between credit spreads and the stock market:

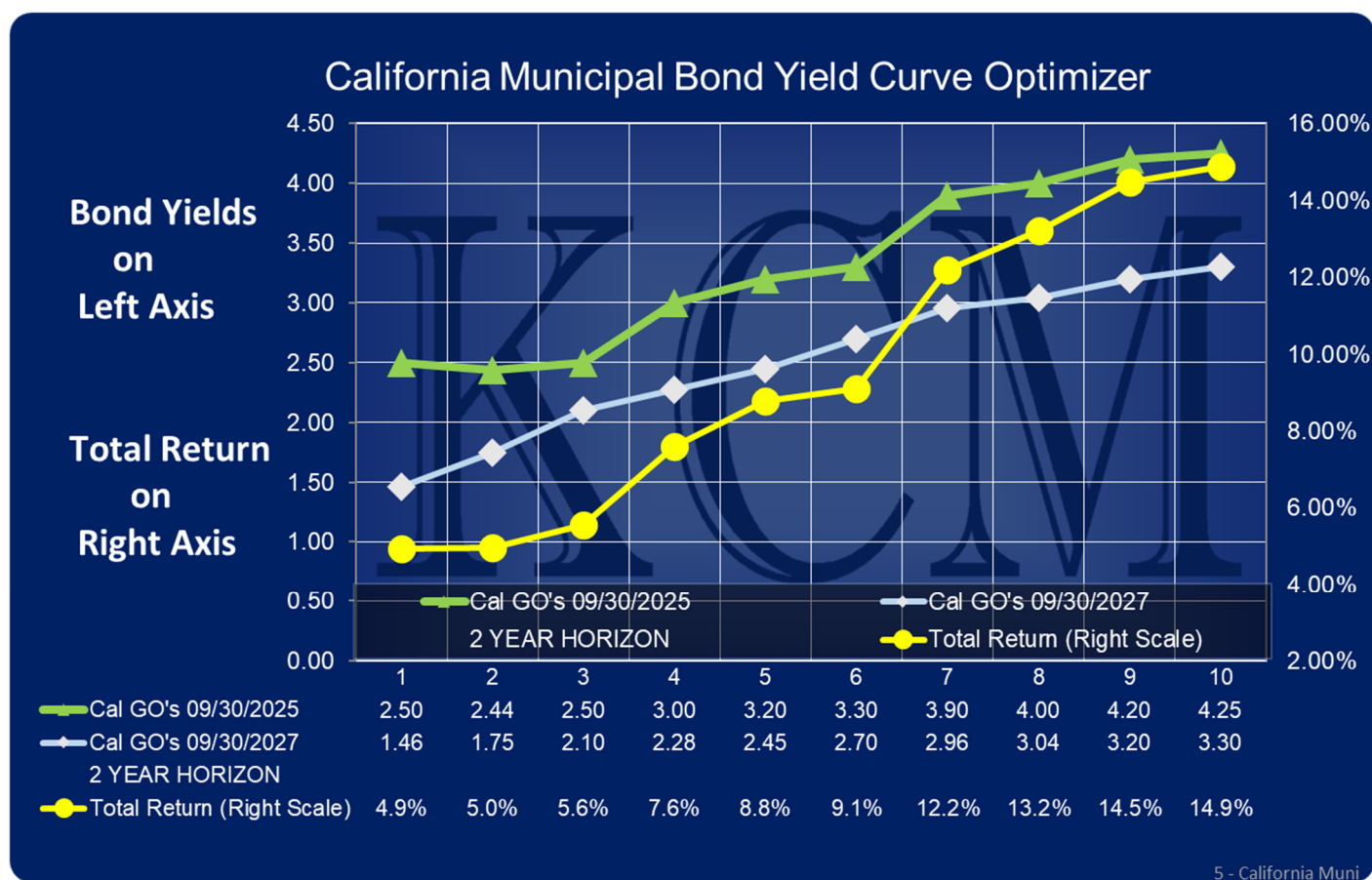
When Spreads Spike, Stocks Drop: During the recessions of 2008 and 2020, you can see massive spikes in the dark blue line (spreads). This indicates extreme fear in the credit markets. At the exact same times, the light blue line (S&P 500) plummeted as investors sold off stocks.

When Spreads Are Low, Stocks Rise: In periods where the dark blue line is low and stable, it signals investor confidence. In these "risk-on" environments, the S&P 500 has generally trended upward.

The Current Situation (Red Arrow): The red arrow points to a recent trend where spreads are exceptionally low and continuing to fall. This suggests that the credit market perceives extraordinarily little risk of corporate defaults, which occurs at the same time as the S&P 500 is reaching new highs. This indicates strong investor optimism in both the debt and equity markets.

This robust credit environment provides a strong foundation for the economy and risk assets. It indicates that the financial "plumbing" of the system is working well.

Fixed Income:



This graph is a financial analysis tool, the proprietary "KCM California Municipal Bond Yield Curve Optimizer," designed to identify the best place on the California municipal bond yield curve to invest in for a two-year period.

Cal GO's 09/30/2025 (Green Line): This is the yield curve for California General Obligation bonds as of September 30, 2025. A yield curve simply plots the interest rate (yield-to-call) you would get for lending money for different lengths of time. As you can see, bonds with longer maturities (e.g., 10 years) offer a higher yield (4.25%) than bonds with shorter maturities (e.g., 2 years at 2.44%). This is normal, as investors typically demand higher compensation for tying up their money for longer.

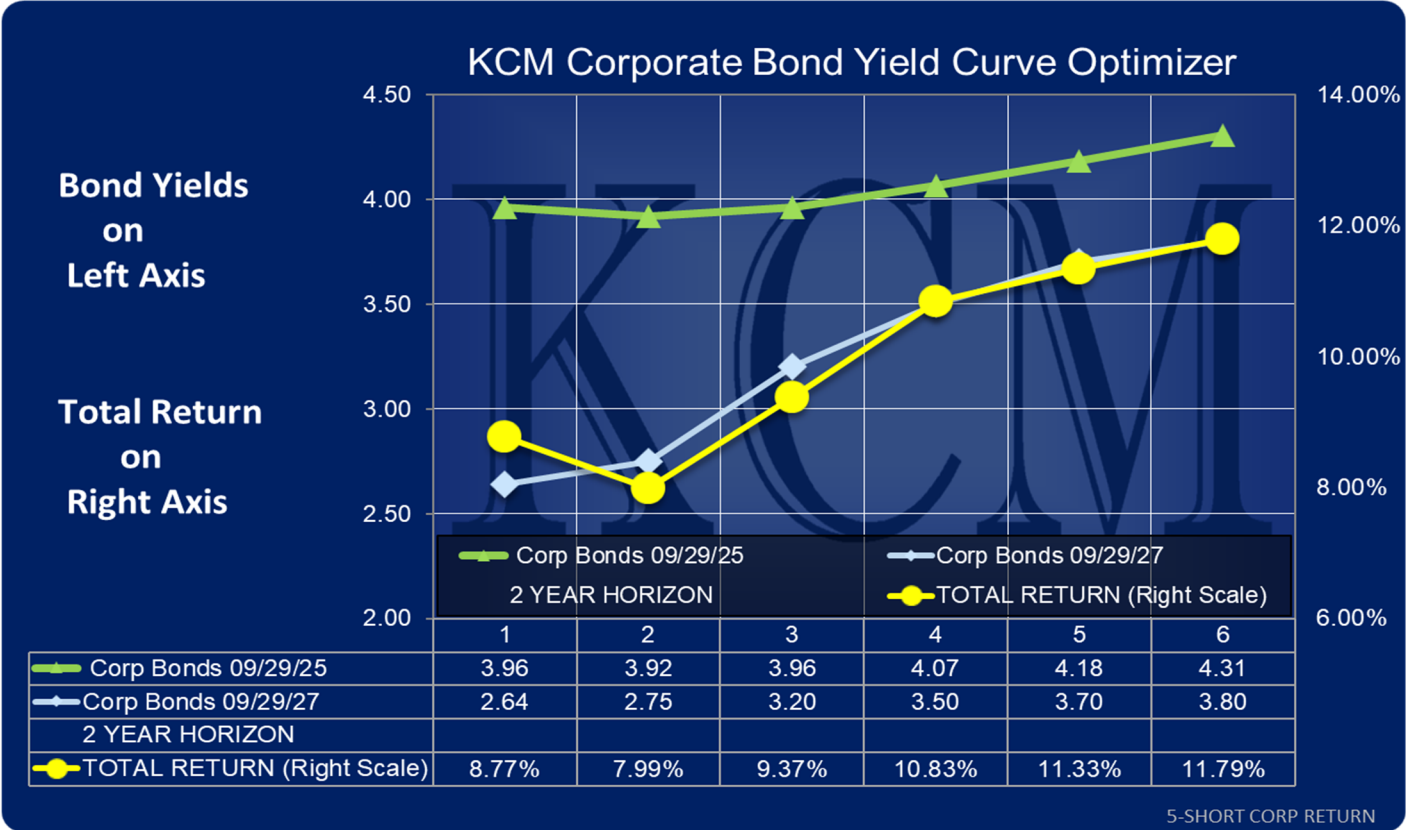
Cal GO's 09/30/2027 (White Line): This is a projected or forward yield curve for two years in the future (September 30, 2027). The chart assumes that interest rates will fall across the board over the next two years.

Total Return (Yellow Line): This is the most important line for the "optimizer." It calculates the estimated total return an investor would achieve by buying a bond today and selling it in two years (on 09/30/2027).

The chart helps answer the question: "If I have a 2-year investment horizon, which bond should I buy today to maximize my return?"

If you bought a 2-year bond today, your total return would be 5.0%. However, by looking at the peak of the yellow "Total Return" line, you can see the optimal choice. Buying a 10-year bond today and planning to sell it in two years is projected to yield the highest total return of 14.9%.

In summary, this chart demonstrates that even with a short investment horizon (2 years), buying a longer-term bond can sometimes provide a much higher total return due to the shape and expected movement of the yield curve. It identifies the 10-year bond as the optimal choice for this specific 2-year scenario.



The proprietary "KCM Corporate Bond Yield Curve Optimizer," graph on the previous page is a financial tool used to decide which corporate bond offers the best potential return over a specific two-year period. It compares bond yields today with projected yields two years from now to find the optimal investment.

What the Graph Shows

The graph plots three different data series against bond maturities ranging from one to six years.

Bond Yields (Left Axis): The green and blue lines show the yields (interest rates) for corporate bonds.

Green Line (Corp Bonds 09/29/25): This represents the current yield curve. It shows that longer-term bonds currently have higher yields. For example, a 1-year bond yields 3.96%, while a 6-year bond yields 4.31%.

Blue Line (Corp Bonds 09/29/27): This represents the projected yield curve two years in the future. The model forecasts that yields for most maturities will be lower in two years.

Total Return (Right Axis): The yellow line is the most important part of the analysis.

Yellow Line (TOTAL RETURN): This shows the calculated total return an investor would receive over a two-year investment horizon for each bond maturity. This return includes both the interest payments received and the change in the bond's price over the two years.

The 'Optimizer' Strategy

The goal is to maximize the total return, not just the starting yield. The total return is calculated by buying a bond today, holding it for two years, and then selling it at the price determined by the projected future yield curve (the blue line).

Here is the key insight: when interest rates fall, bond prices rise.

Let us look at the 6-year bond as an example:

An investor buys it today with a yield of 4.31% (green line).

They hold it for two years, collecting interest payments.

After two years, it is now a 4-year bond. The graph projects that a 4-year bond at that time will have a yield of 3.50% (blue line).

Because the market yield (3.50%) is now lower than the yield the investor locked in (4.31%), the bond's price has increased.

The investor's total return is the combination of the interest they received plus the capital gain from selling the appreciated bond.

Key Takeaway

According to this model, the optimal strategy for a two-year investment horizon is to buy the 5-6-year bond. They are projected to provide the highest total returns, as shown by the peak of the yellow line. This strategy, known as "riding the yield curve," aims to profit from both the bond's interest payments and its price appreciation as it "rolls down" to a lower point on the future yield curve.

The Fourth Quarter Rally

Historically, the fourth quarter (October through December) has been the strongest period for U.S. stock market returns. This phenomenon, often referred to as the "Santa Claus Rally" in its latter stages, is driven by several factors, including holiday optimism, the investment of year-end bonuses, and institutional portfolio window-dressing.

Given the strong macroeconomic fundamentals already in place, this seasonal tailwind could provide an extra boost to market performance heading into year-end. The confluence of a dovish Fed, moderating inflation, and positive seasonality creates a potent backdrop for equity investors.

Conclusion

The U.S. economy and financial markets have entered a pivotal phase in late 2025, characterized by the Federal Reserve's first rate cut of the cycle, two more anticipated cuts, resilient but slowing growth, and broadly supportive inflation data. Recent policy actions have resulted in lower short-term rates, while longer-term Treasury yields remain range-bound due to global demand and fiscal considerations. Mortgage rates have dipped near 6.5%, and the equity market continues to push record highs, buoyed by improved earnings, capital flows, and robust consumer spending. Core inflation (PCE) remains contained at 2.9%, and oil prices are range-bound, reducing future inflation risks. Initial jobless claims have surprised to the downside, and retail sales/income have modestly exceeded expectations. Although the labor market faces structural challenges—such as a reduced supply of legal workers and downward payroll revisions, productivity gains driven by AI advances are cushioning wage pressures. With a weak dollar supporting corporate earnings, money supply expansion, and \$7 trillion in cash on the sidelines, financial conditions remain favorable across risk assets. Credit markets are healthy, and credit spreads remain historically tight. As the fourth quarter—historically the strongest for equities—begins, the U.S. stands poised between continued growth and vigilance, making this a distinctive "Goldilocks" moment for diversified portfolios.

Feel Free to Call Us

We are always available to address any questions or concerns you may have. We sincerely appreciate your trust in KCM and the valuable referrals you may provide. We remain committed to exceeding your expectations in all aspects of our service.

Jay Kellett - Founder and CEO

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