

The Fog Is Lifting

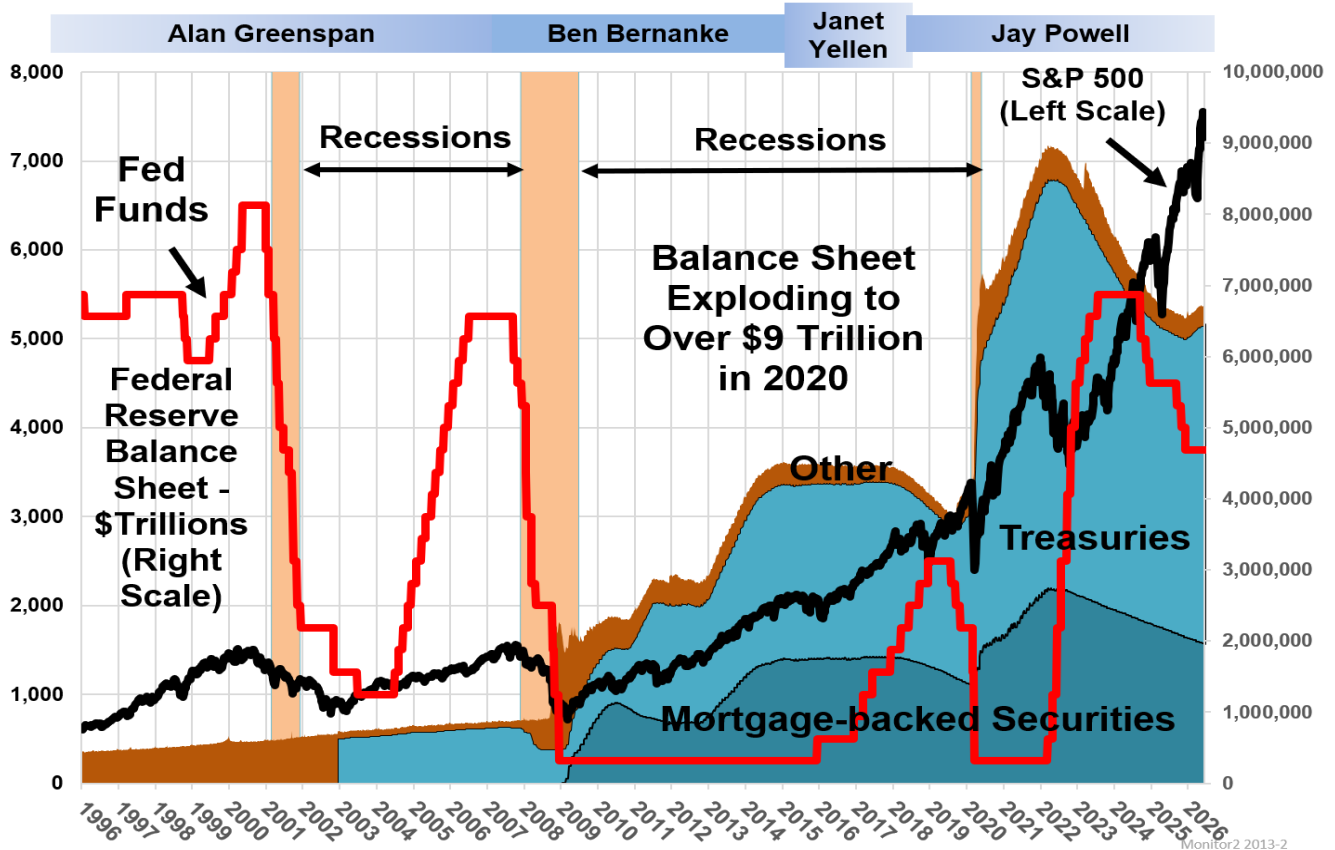
A Historical Perspective: Liquidity-Driven Markets

In our KCM April Commentary, we rigorously reviewed our January investment thesis through the lens of the “**Fog of War.**” War in Iran had degraded the reliability of traditional financial forecasts, introducing severe commodity volatility, energy supply disruptions, and deep policy uncertainty.

Today, the fog has mostly rolled out. We are still navigating a few macroeconomic speed bumps, but we have swapped out **some** active geopolitical guesswork for a clearer, scenario-based approach. By tuning into the forward-looking "market-based signals" favored by new Fed Chair Kevin Warsh, we can get a real, unvarnished look at **current economic conditions** and try to figure out where near-term Fed policy is actually headed. It is pretty clear to us that under the new Chair, the Fed's path has shifted toward **tighter financial conditions**. **The central bank is taking a firm stand against re-accelerating inflation by potentially pulling both levers at once: hiking short-term interest rates and shrinking its massive balance sheet through Quantitative Tightening (QT), despite political pressure for lower rates.**

Following a sharp pullback in the first quarter of 2026, the markets finally found their footing and bottomed on March 30, 2026. Since that pivot point, stocks have staged a ferocious comeback, powered primarily by a spectacular 49+% surge in the technology sector.

From 3/30/2026	Total Names	Total Winners	Percent Winners	Percent That Beat Sector Return	Sector Return
Consumer Discretionary	48	36	75.00%	43.75%	11.22
Consumer Staples	36	22	61.11%	52.78%	2.16
Energy	22	4	18.18%	59.09%	-13.67
Financials	75	59	78.67%	47.37%	11.24
Real Estate	31	26	83.87%	58.06%	10.45
Healthcare	58	37	63.79%	43.10%	10.80
Industrials	79	62	78.48%	31.65%	18.56
Information Technology	73	57	78.08%	35.62%	49.54
Materials	26	19	73.08%	57.69%	3.93
Communication Services	22	10	45.45%	47.83%	-0.51
Utilities	31	18	58.06%	64.52%	-0.68



The chart above clearly illustrates the tight correlation between the Federal Reserve Balance Sheet (right scale, stacked area) the Fed Funds rate, and the performance of the S&P 500 (left scale, black line).

- Following the Great Financial Crisis, the post-2009 bull market was heavily supported by Ben Bernanke’s Federal Reserve’s unprecedented liquidity injections, a sharply lower Fed Funds rate of 0.25% from December 2008 to December 2015, and a Fed balance sheet that increased by over \$4 trillion. (Quantitative Easing).
- This dynamic peaked in 2020 when under Jay Powell the balance sheet exploded to over \$9 trillion, creating a massive liquidity floor that propelled equity valuations aggressively upward.

Policy Shifts and Recessions

In the chart above the orange vertical bands mark historical periods of economic recession, which have consistently been preceded by specific Fed actions:

- Major equity stress and economic contractions historically coincide with cycles where the Fed aggressively raises interest rates (red line) while simultaneously attempting to withdraw liquidity, a possibility under Kevin Warsh.
- We also note a distinct lag effect. As seen in the 2000–2001 dot-com bust and the 2007–2008 financial crisis, market corrections typically occur after the Fed Funds rate peaks and begins to flatten or rapidly reverse, underscoring the lag with which tightening hits the real economy.

The Composition of the Balance Sheet: The MBS Dynamic

The breakdown of the balance sheet into its components reveals a critical risk factor for today's market:

- **Mortgage-Backed Securities (MBS):** Notice that from 2009 onward, MBS (dark blue area) became a structural cornerstone of the Fed's asset holdings. By functioning as a continuous buyer, the Fed artificially compressed mortgage spreads to stimulate housing.
- **The Current Runoff:** The sharp taper on the right side of the chart shows the ongoing balance sheet contraction (Quantitative Tightening) heading into 2026. The explicit roll-off of these mortgage assets removes the Fed's dominant bid, partially explaining why consumer mortgage rates face compounding upward pressure even when benchmark Treasury yields stabilize.

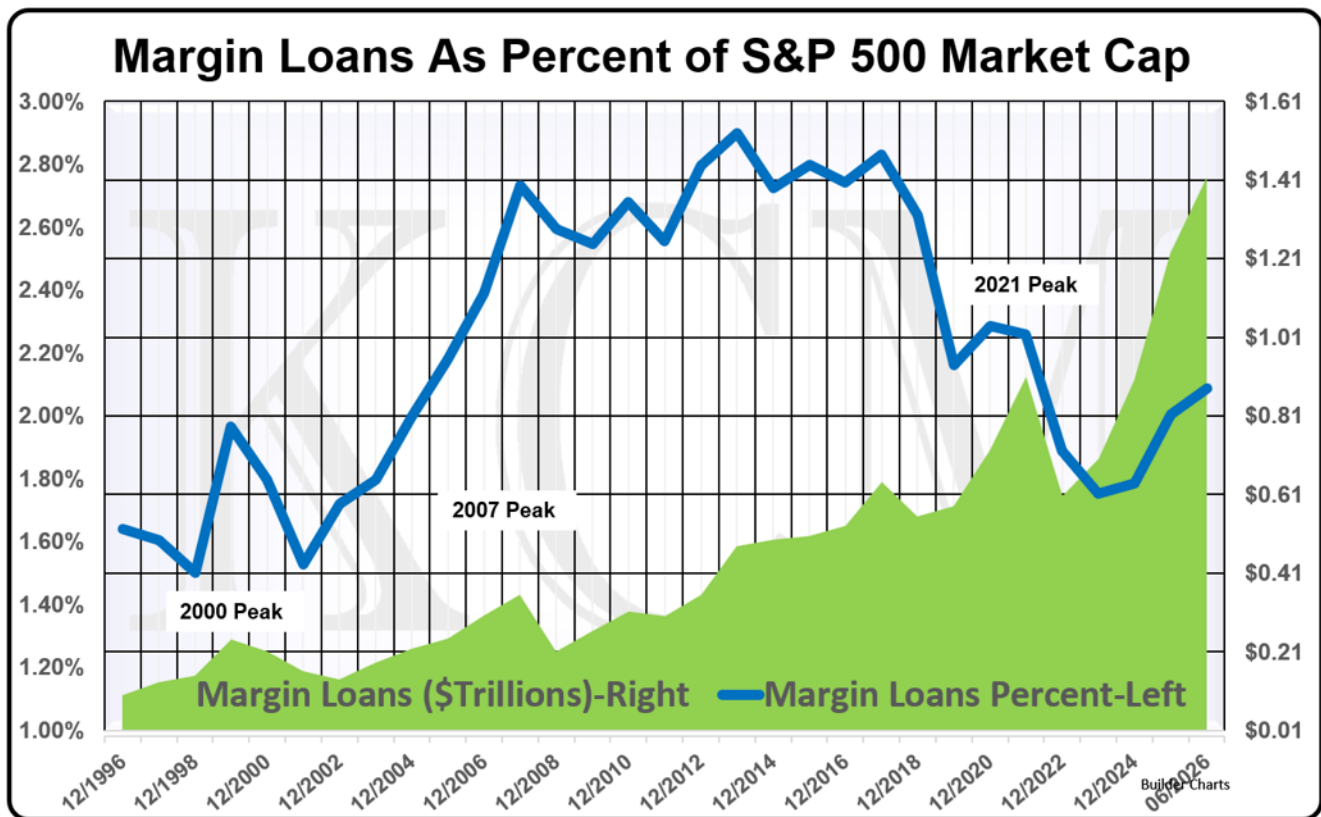
Current Outlook: Navigating the 2026 Tightening Regime

Looking at the far right of the timeline (2025–2026), the economy is entering historically rare and contractionary territory:

- **Dual-Lever Tightening:** While the Fed Funds rate had initially leveled off around 3.50%–3.75%, persistent inflation pressures mean the market is pricing in a potential resumption of rate hikes.
- **The Risk Profile:** If the Fed pursues rate hikes while aggressively shrinking the balance sheet, it removes liquidity from two directions at once (tightening both the *price* and the *quantity* of money).

As the chart's historical cycles remind us, this combination traditionally compresses equity valuation and elevates market volatility. **Draining this liquidity too quickly represents the classic tail-risk policy error, a painful historical lesson we hope Kevin Warsh pays close attention to.**

Liquidity Driven Market: Two Different Stories, Absolute Debt vs. Relative Leverage



A recent Wall Street Journal article pointed out the historically high margin balances in investors stock portfolios, raising a concern that this historically high number may indicate a near-term stock market bubble. Maybe not. (Historical data from FINRA)

The above chart plots two distinct metrics that reveal a divergence in recent years.

- **Margin Loans in Dollars (Green Area, Right Axis):** This represents the raw volume of money investors have borrowed against their portfolios. It has grown exponentially, skyrocketing from a fraction of a trillion in the late 1990s to an all-time high of over \$1.41 trillion in 2026.
- **Margin Loans as a % of Market Cap (Blue Line, Left Axis):** This scales the borrowed money against the total value of the market. While absolute debt is at record highs, relative leverage actually peaked between 2014 and 2018 at over 2.80%. As of mid-2026, it sits around 2.10%, meaning that while debt is massive, the overall size of the stock market has grown even faster.

Historical Context of Major Market Peaks

Margin debt is highly cyclical and often serves as a barometer for investor euphoria and systemic risk. The chart above explicitly flags three major market tops:

- **2000 Peak (Dot-Com Bubble):** Margin debt as a percent of market cap spiked rapidly to about 2.00% before collapsing alongside the tech crash.

- **2007 Peak (Great Financial Crisis):** Relative leverage surged even higher, hitting roughly 2.75% right before the housing market and banking sector collapsed.
- **2021 Peak (Post-Pandemic Boom):** Absolute margin debt hit a massive structural peak, while the relative percentage saw a sharp, brief spike to around 2.30% before the 2022 market correction forced a wave of deleveraging.

The Current Outlook (Mid-2026)

Looking at the far right of the chart, we are seeing a sharp, vertical surge in absolute margin loans (the green mountain). However, because mega-cap stocks have ballooned the overall S&P 500 market cap, the blue line is rising at a more moderate pace.

The Takeaway: Investors are borrowing more money than ever before in absolute terms, but because the market is so heavily capitalized, the *percentage* of leverage hasn't quite reached the danger zones seen in 2007 or 2015–2018.

The current level of margin debt, which has surged to a record \$1.41 trillion, has a profound impact on market dynamics. While leverage fuels a bull market on the way up, it inherently creates structural vulnerabilities.

The biggest systemic risk of high margin debt isn't the debt itself, but how it behaves during a correction. It creates a highly reactive, circular feedback loop:

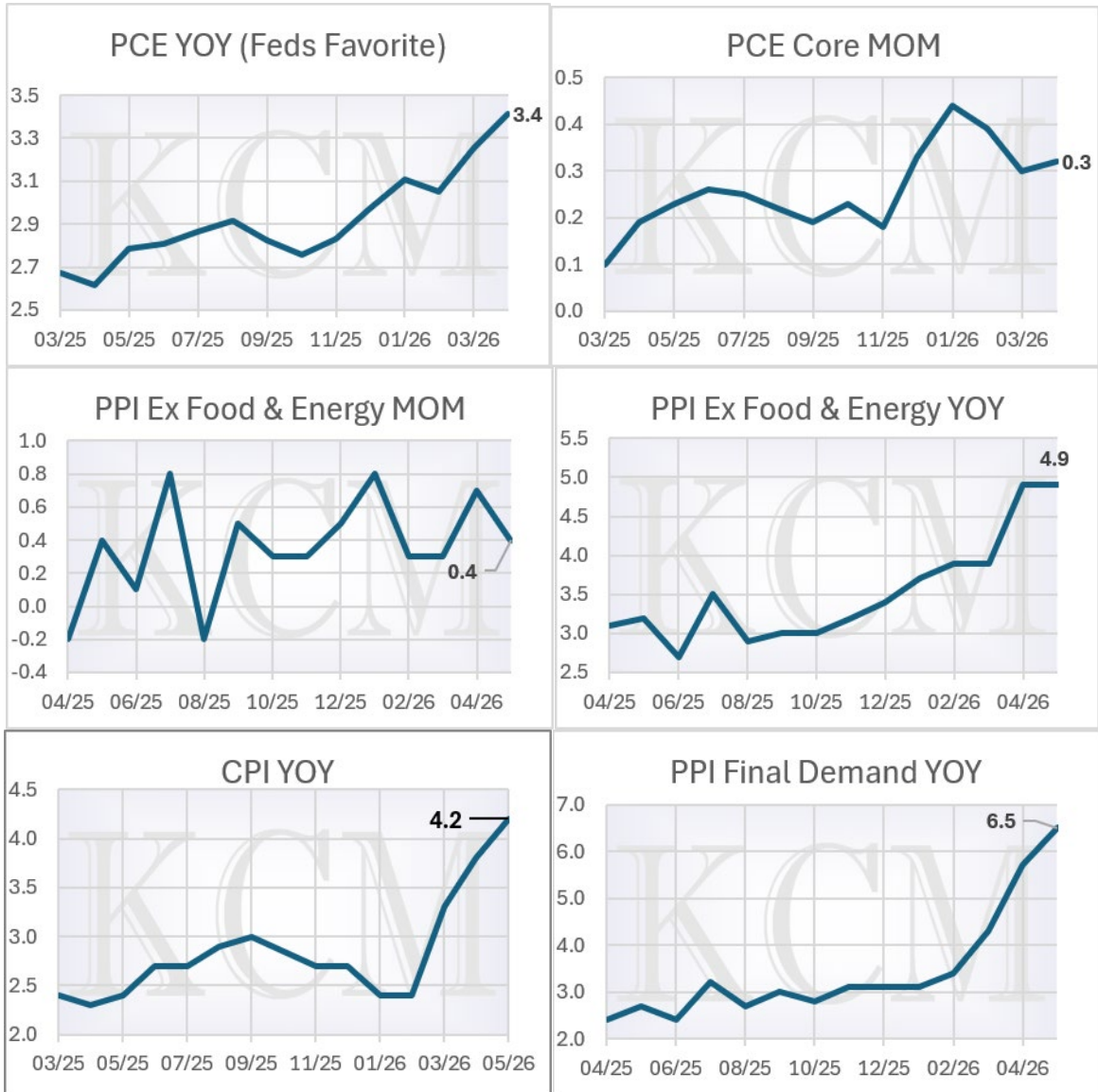
1. **The Trigger:** A normal market correction occurs due to macro events (e.g., interest rate jitters or geopolitical friction).
2. **The Call:** As portfolio values drop, investors' equity falls below the maintenance margin required by brokerages.
3. **The Cascade:** Brokers automatically liquidate stocks to cover the loans. Because brokers sell whatever is liquid, this forced selling drives prices down further, triggering *more* margin calls for *other* investors. What begins as a minor pullback can quickly cascade into a severe downturn.

The Silver Lining: The "Denominator Effect"

Despite the staggering \$1.41 trillion figure, the blue line on the chart (Margin Loans as a Percent of Market Cap) has prevented an immediate collapse. Because the total value of the S&P 500 has expanded so massively, the relative burden of this debt sits around 2.10%, well below the dangerous 2.80%+ levels seen before the 2008 financial crisis. The market's immense size provides a cushion that absorbs some of the risk.

Summary: The current level of margin debt acts like an accelerant. It does not *cause* a market crash on its own, but it ensures that whenever the next natural market downturn happens, the speed and severity of the drop will be significantly magnified. It leaves the market with a very low margin for error.

Inflation indicators remain well above the Fed's stated target of 2%.

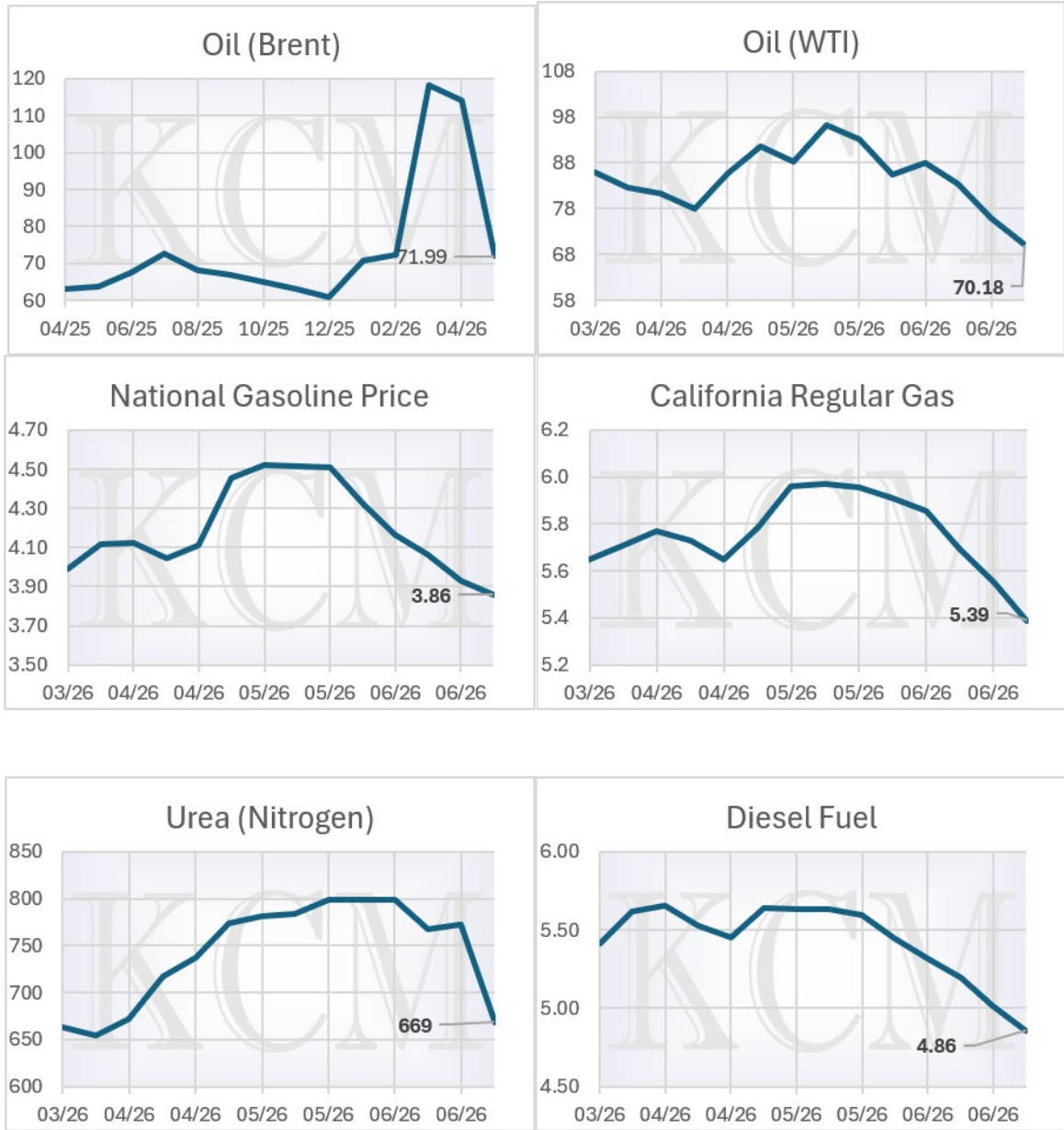


The Fed's favorite inflation indicator, Personal Consumption Expenditures (PCE), has accelerated to 3.4% year-over-year, well above the Fed's stated target of 2.0%. In the current 2026 economic landscape, tracking the PCE trajectory has been paramount for anticipating monetary policy moves. Core PCE's climb from 3.0% in December 2025 to 3.3% in April 2026 signaled a meaningful re-acceleration of structural inflation. This metric provided the primary data justification for new Fed Chair Kevin Warsh to shift the central bank toward a hawkish regime of tighter financial conditions, keeping short-term interest rates elevated.

PPI stands for Producer Price Index, a measure of wholesale inflation that refers to the cost of raw materials for producers before they add a sales price to consumers. It can be an early warning that higher Consumer Prices (CPI) are in the pipeline.

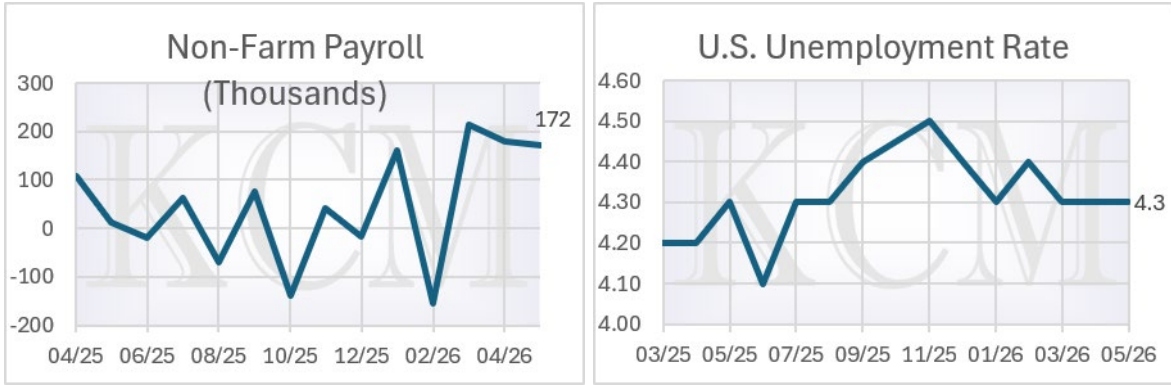
The 6.5% surge PPI Final Demand signals a potential future significant increase in future inflation.

The American Consumer, Resilient Foundation, Eroding Edges

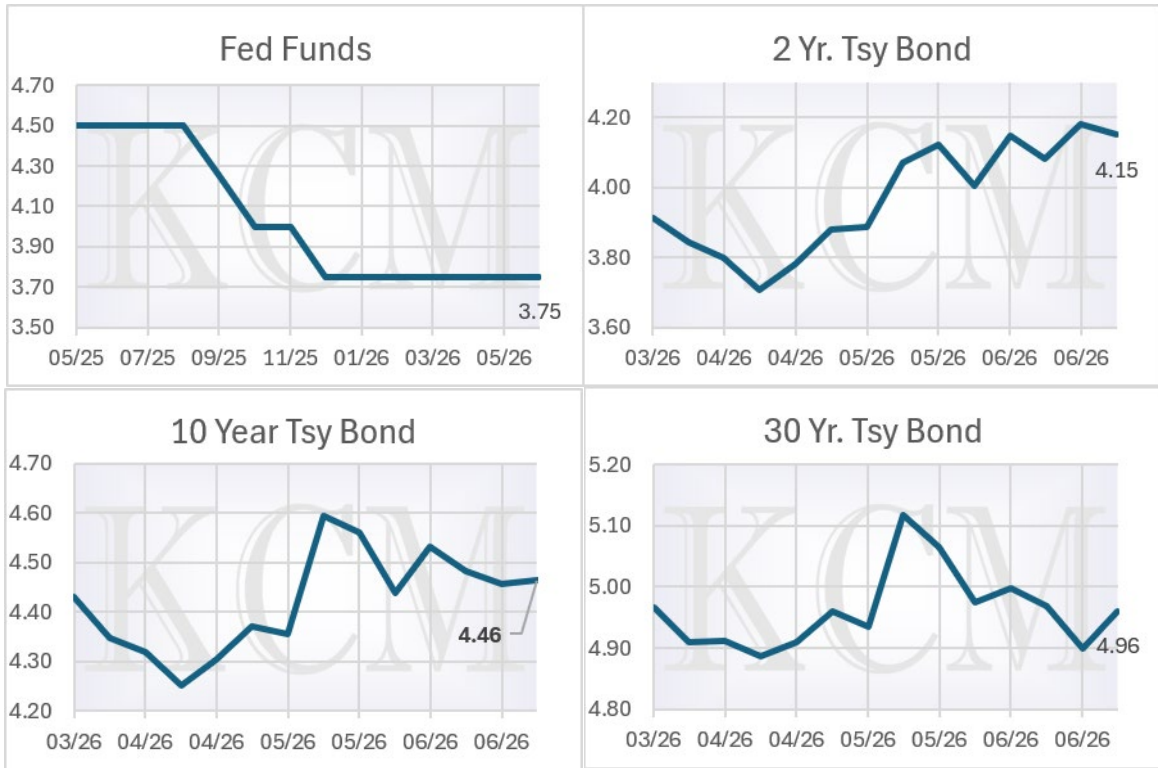


Despite rising nominal incomes and crude oil, gasoline, and fertilizer prices that have declined from their March worldwide highs, war-driven commodity inflation operates as a *de facto* tax on consumption. Higher costs at the pump, elevated grocery costs, and rising utility bills continue to crimp household discretionary spending.

The American Consumer, Resilient Foundation



The core structural underpinning of the American consumer, personal consumption expenditures (which account for about 70% of the total U.S. economy), remains durable. There has been no mass layoff cycle, and the labor market has firmed meaningfully. Private payrolls averaged 117,000 per month through May 2026 versus just 10,000 per month in 2025, keeping unemployment low at 4.3%.



Monetary Policy: The Fed Tailwind Meets the Stagflation Headwind

- **The Policy Shift:** The proactive, sustained rate-cutting mode assumed earlier this year has reversed. The supply-side inflation shock, higher oil and commodity prices, created a potential stagflation scenario that ended the simple "cut rates = good for stocks" logic.
- **The June Reality:** The FOMC held the policy target rate at 3.50%–3.75% at its June 17 meeting. However, market-driven yields sit significantly higher: the 2-Year Treasury is at 4.09%, while the 10-Year and 30-Year bonds sit at 4.37% and 4.87% respectively following the new Chairman's debut. See charts on the previous page.
- **Behind the Curve:** With the short end of the market curve tracking well above the current policy rate, investors are explicitly pricing in tighter monetary policy. The market is effectively telling the Fed that current conditions remain too loose. Conversely, the slight flattening or moderation at the long end indicates tentative market confidence that inflation will be contained over a longer horizon.
- **The Warsh Action Plan:** To achieve "price stability," a phrase Chair Warsh mentioned 12 times in his first press conference, the Fed is expected, despite President Trump's plea for lower rates, to adopt a hawkish stance. This potentially means raising the policy rate closer to the 4.25%–4.50% range to catch up with market realities.

Fiscal Policy: The Big Beautiful Bill and the Tariff Clarity Assumption

- **Durable Provisions:** The legislated tax refund injections (projected at \$191 billion) and 100% bonus depreciation rules are real, enacted mechanisms already flowing through the pipeline. War does not reverse domestic tax legislation.
- **Lower Multipliers:** However, the stimulative multiplier of this fiscal injection is partially swallowed by a war-driven inflationary environment. Households receiving refunds face higher gasoline and grocery bills, leaving them with lower net purchasing power than originally projected.
- **Regime Uncertainty:** The assumption that peak tariff uncertainty had passed was over-optimistic. Strategic conflict involving major trading partners introduces significant "regime uncertainty," reopening trade policy debates and keeping corporate supply chain strategies in a state of prolonged flux.
- **Geopolitical Volatility:** Sustained low oil prices were the single biggest casualty of geopolitical disruptions. Crude oil previously experienced a massive supply shock, with Brent Crude spiking from roughly \$59 to a peak of almost \$120.
- **The Current Plateau:** Brent crude has since pulled back to about \$72 and West Texas Intermediate (WTI) crude has also pulled back and settled near \$69. Clearly, the structural landscape has changed.
- **Continuing Headwinds:** Lower energy prices will again be a stealth tax cut; but not just yet. They are still operating as a baseline cost burden, and gas prices need to continue to come down to reflect the sharp decline in crude prices. That always takes time. Regular unleaded

gasoline in California was about \$4.00 /gallon in January of 2026. Lower input cost will eventually lead to margin expansions, becoming a tailwind to the corporate profit outlook. However, that, too, will not happen overnight.

Inflation and the AI Productivity Miracle: The Most Resilient Pillar

- **Structural Insulation:** The "AI Productivity Miracle" stands as our most resilient, war-resistant economic driver. Software deployment and enterprise workflows do not stop when commodity channels fragment.
- **Workflow Efficiencies:** Agentic AI continues to compress costs, streamline operations, and allow companies to expand output without proportional increases in headcount.
- **Important Qualifications:** While AI allows companies to absorb higher domestic labor costs by lowering unit expenses, it offers a less direct offset against lingering high energy and utility costs. An AI-optimized logistics operation or factory still has to pay for fuel and electricity. Furthermore, macro-uncertainty may shorten corporate planning horizons, extending the timeline needed to fully operationalize these strategic gains.

Bond Yields, Credit Spreads, and the Yield Curve

The dual tightening mechanism now on the table—raising the fed funds rate while subtracting from the balance sheet via Quantitative Tightening (QT)—is unusually contractionary, removing liquidity from the system from two directions simultaneously.

The Mortgage Spread Impact: Mortgage rates face severe compounding upward pressure. As Chair Warsh stops reinvesting in Mortgage-Backed Securities (MBS) and allows them to roll off, the Fed systematically exits as a primary buyer. This removes a vital market bid, widening the spread between mortgage rates and Treasury yields. Affordability may deteriorate, mortgage refinancing activity may slow up, and housing-sensitive sectors may face continued pressure.

- **Abundant System Liquidity:** On a positive note, investors are hoarding a massive amount of dry powder, driving Cash in Money Market Funds to an all-time record high of **\$7.919 Trillion**. This, combined with recovering Money Supply (M2) YoY growth of 4.7%, means the broader financial plumbing retains abundant liquidity.
- **Credit Quality:** Credit risk remains remarkably low, as demonstrated by the tight Junk Bond Spread at 302 bps. However, tight spreads are a peacetime condition that can gap wider non-linearly if risk aversion spikes. We strictly favor investment-grade bonds, Treasuries, and high-grade municipal debt as critical portfolio ballast.

The Equity Market Outlook: Re-evaluating the S&P 500

Simultaneous rate hikes and aggressive balance sheet runoff represent a fundamentally equity-unfriendly combination. Reversing both liquidity levers compresses equity valuations through higher discount rates and shrinks the exact reserve base that fueled the post-2009 bull market.

- **Valuation Compression:** We may get elevated market volatility and multiple compression, leaving long-duration growth and concentrated tech-growth portfolios particularly vulnerable. Forward S&P 500 estimates face input costs and demand disruptions.
- **The Counter-Weight: This is a regime of tighter financial conditions, not an outright crash.** The balance-sheet reduction is explicitly designed to be slow and gradual to avoid a liquidity air-pocket. More importantly, the stable labor market gives the Fed room to prioritize inflation without immediately fracturing real economic activity.

Conclusion: The Wisdom of Discipline, Quality, and Staying the Course

The transition out of the geopolitical fog demands a shift from a concentrated, high-conviction expression of the bullish thesis to a scenario-aware portfolio construction. In our judgement the appropriate investment posture is straightforward: **stay invested in KCM BlueBlood stocks and high-quality bonds.**

- **Stick with KCM BlueBloods:** In equities, we suggest prioritize large-cap, U.S.-based multinationals with durable competitive advantages, diversified global revenue streams, fortress balance sheets, and explicit pricing power. These enterprises possess the structural capability to capture AI productivity gains, withstand energy input shocks, and harvest mechanical currency translation advantages when the dollar shifts.
- **Maintain High-Quality Bonds:** In fixed income, rely on investment-grade holdings to deliver necessary income, capital preservation, and tactical liquidity. This dry powder and diversification ensures the stability needed to take advantage of potential equity dislocations rather than being forced to sell into them.

Great businesses and sound credit endure. Temporary policy adjustments do not erase long-term value, and the discipline to stay invested when the financial headlines shift remains one of the most reliable pillars of investing alpha.

To be clear: I am not predicting an imminent market top.

History shows that investor mania can run much farther than logic dictates. Back in December 1996, amid the early dot-com boom, the recently deceased Fed Chairman Alan Greenspan famously warned that "irrational exuberance" was inflating asset prices far beyond their fundamental economic value. It felt like a definitive swan song. Yet, despite that dire warning from the world's most powerful central banker, the market surged about another 100% before finally peaking nearly four years later in September 2000.

Fast forward to today: the market is undergoing a remarkably similar parabolic melt-up, this time fueled by the massive expectations for the artificial intelligence revolution. While leverage and valuations are undeniably stretched, history reminds us that secular tech revolutions can sustain immense upward momentum for a lot longer than investors care to admit.

As we stated in our last quarterly communication, we are aware that we will never achieve perfect accuracy in our forecasts, and there may be additional challenges ahead. But we will always be available to navigate and adjust through them with you, and once again thank you for your faith in us. All of us at KCM wish you a delightful summer.

Jay Kellett

Founder & CEO,

KCM Investment Advisors LLC

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