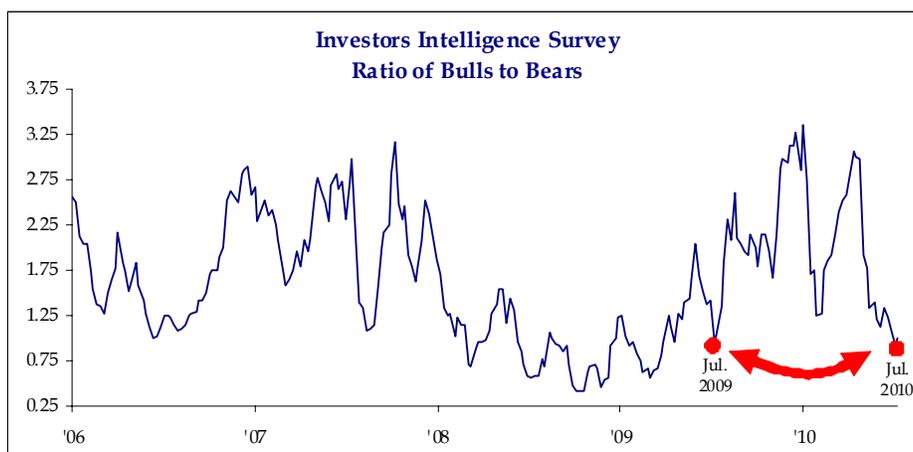


## KPCM 2<sup>ND</sup> QUARTER 2010 REVIEW AND OUTLOOK

The global credit crisis of 2008-2009 is still reverberating throughout the free world economic system. In the U.S., investor concern centers around the fear of the economy slipping back into another recession. Given that recent employment statistics (a critical component to a sustained recovery) have been somewhat anemic, investor concern may seem justified. Additionally, despite record low interest rates, demand for housing remains tepid. In fact, housing starts are dramatically below normal replacement cycle demand. Consumer spending, which picked up in the second half of 2009, seems to have slowed to the point where it may not exceed the levels of the second half of last year.

In Europe, the fear of another credit crisis overshadows the markets as Greece, Spain and other countries implement significant budget cuts to reduce their excessive sovereign debt accumulated over the last 10 years. Even in Asia, Japan continues to stagnate while China periodically “taps the economic brakes” to bring growth rates down to more moderate levels.

Economists around the world are now debating whether the global economy will enter a new inflationary or deflationary cycle. The last economic recession, induced by a decade of financial leverage and lax financial oversight, created the worst economic decline since the 1930’s Great Depression. Regardless of what the economists think, it is no surprise that investors remain skeptical and overwhelmingly bearish on the equity markets.



*Source: Strategas*

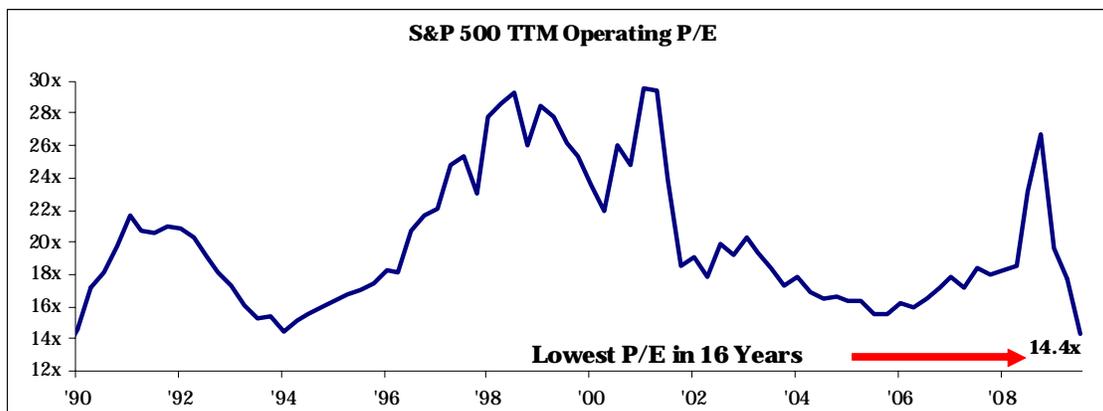
We remain skeptical that the “expert” financial analysts and economists that failed to see this economic downturn in 2008-2009 now have the insight to address just how the economy will ultimately emerge from its current position. We are not surprised at the conflicting opinions now buffeting the global financial markets. At KPCM, we are more inclined to pay attention to comments and insights from the business leaders of global corporations. Many companies by and large were able to successfully manage through the financial and economic crisis of 2008-2009 and emerge in a stronger financial and competitive position. Importantly, these corporations are reporting that business in general is improving on the margin. While revenues may be coming in a bit below

expectations, the tone and bias being reported by most of these companies is that (while cautious), business seems to be slowly getting better. Moreover, U.S. corporations are sitting on over \$1 trillion in cash; a record amount despite unusually low interest rates. We are beginning to see some companies commit to redeploying this cash to acquisitions and/or higher dividends. Regardless, this cash remains a major untapped long-term stimulus to the economy once a recovery begins to accelerate. Overall, corporate profits are still growing and should continue to increase into 2011 and beyond.

At KPCM, we do not profess to have a better crystal ball than all the “experts”. We recognize that the U.S. government has not created a good environment for business. The stimulus programs have not been as successful as hoped. Congress still is focused on taxing individuals to offset its current spending programs and we are very concerned by the ever growing federal deficits. Nevertheless, we believe these problems are well documented and thus, are likely to be more directly addressed and corrected in the future than left to erode.

Importantly, the U.S. and European countries have moved aggressively to stabilize the world banking system. Recently, the Economic Union completed stress tests that imply that the vast majority of European financial institutions can withstand significant further stress. U.S. and many European and Asian companies are in excellent financial health. Global business is ready to respond to any real signs of a recovery. Additionally, the U.S. jobs recovery, while modest, is moving upward. If this trend continues, some acceleration in job formations may occur by year end. We think it is premature to assume deflation and another recession. Indeed, we would prefer (and expect) to see sub-par economic growth of 2 ½ - 3 ½ % in GDP and some modest inflation in the next few years. This would suggest that the global economy continues to deleverage while avoiding massive inflation (or, much worse, a deflationary) risk. If modest inflation begins to emerge, it would also suggest that global demand is recovering.

In terms of the U.S. equity market, the critical issue that has created a great deal of equity underperformance over the last five to ten years can be summed up in two words: valuation compression. Simply put, the market is placing a low valuation (price earnings ratio) on current and future earnings.



Source: Strategas

The “Bears” will argue that the low valuation reflects the poor economic conditions in the U.S. and Europe and concern of deflation or potential for a further credit crisis overseas. Clearly valuations have rarely been this low when compared to global interest rates.

We tend to view “this glass” as half full rather than half empty. We believe the market is likely discounting a very weak economic environment in the future. Thus, as the global economy improves and the U.S. ultimately begins to address its debt issues, equity valuations should rise. A second factor depressing valuations has been the focus on short term trading and the use of leveraged ETF’s. Both focus on factors that have little to do with investing in companies. Rather, computerized program trading and investing using levered indexes tend to exacerbate individual equity price fluctuations which can negatively impact valuation metrics.

Additionally, the U.S. government has added fuel to this mentality of trading by eliminating the up tick rule (for shorting equities), not regulating computerized trading programs, and threatening a rise in taxation of long-term capital gains and dividends. Why the government does not increase taxes on high frequency trading, and other forms of programmed day trading (all of which create increased volatility) rather than on long term investors strikes us as another clear sign that Congress and the SEC still do not understand the damage these computerized trading programs have done. In any case, we believe valuations have reached levels where it is discounting a decline in corporate profit expectations; a position which we believe is not likely to occur. Alternatively, it is also possibly discounting a sharp rise in interest rates; also an unlikely scenario near to intermediate term.

Our core portfolio strategy has not changed. We continue to position our equity exposure in world class companies that should enjoy significant growth in developing nation markets in the future. We believe that U.S. and European growth will continue to be lower than many Asian and Latin American countries. Thus, we remain focused on multinational investments in companies uniquely positioned in these markets.

As an example, we have established a position in Omnicom (OMC), the largest global advertising and marketing services company in the world. OMC is poised to benefit from the global recovery in advertising and promotion. Omnicom is also active in internet advertising and more recently it announced a partnering with Google for online display advertising. Lastly, it is positioned to benefit from the growth in advertising in the developing nation markets. Omnicom is selling at the low end of its historical valuation range despite generating accelerating revenue growth in recent quarters. Needless to say, we believe this is an opportune time to own this company.

We remain conservative in our expectations for economic recovery and for overall returns this year. We are very focused on preservation of our client's capital. As a result, we are prepared to move quickly should economic problems again overwhelm our expectations for a slow global recovery. As always, please contact us with any questions you may have regarding our outlook and/or your investments.

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