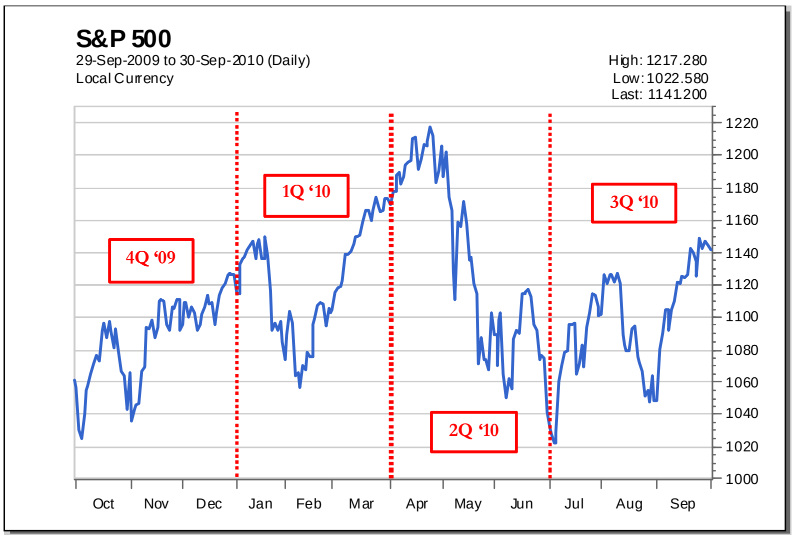
KPCM 3RD QUARTER 2010 REVIEW AND OUTLOOK

The global equity markets swooned dramatically in the spring and summer of 2010, only to reverse course and recover much of the earlier declines through September. Generally, market volatility is not uncommon after exiting a severe recession. In particular, investor concerns remain elevated as the views regarding the degree of economic recovery vary significantly among analysts, economists, and "those in the know." As such, the U.S. stock market could well continue to be volatile over the intermediate term.



Source: Strategas Research

The global market downturn between April and June specifically reflected fears regarding possible sovereign debt defaults in a number of smaller European countries (Greece, Italy, Ireland, …). While European governments attempted to address the issues through fiscal austerity and budget measures, the news media continuously highlighted the demonstrations, social unrest, and overall unease by the citizens of the affected countries. Additionally, there were signs suggesting that the U.S. economic recovery was stalling. As such, the pullback in the global markets was swift and unrelenting.

However, the corporate profit recovery from the 2008 recession lows remains on track. To date there are no sovereign debt defaults and budget measures continue to be implemented in Europe. Economic trends are also beginning to emerge that suggest that Europe and Asia are in an early economic recovery period. Even in the U.S., clear signs are emerging that middle and high-income consumers are returning to the stores to shop. The hotel industry is reporting a (modest) recovery in business travel, and global industrial companies are prospering due to the continued strength in the emerging markets. Except for the continued disappointing trends in housing and employment, the U.S. (and the global) economy, appear to be recovering albeit in "fits and starts."

Even with the improvement in global economic trends and the recovering equity markets, neither are strong enough to convince the individual investor to return to the equity markets. As seen in the following charts, investors continue to pour money into fixed income securities in lieu of equities.

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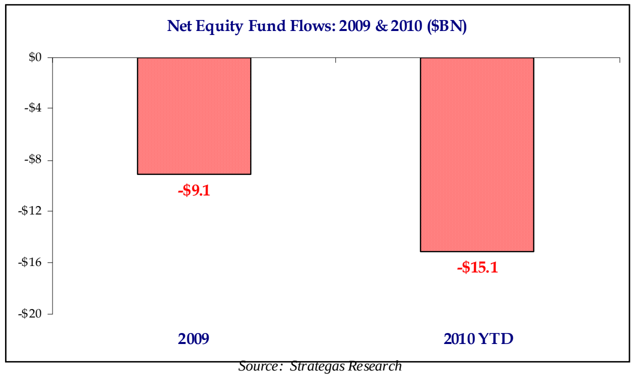

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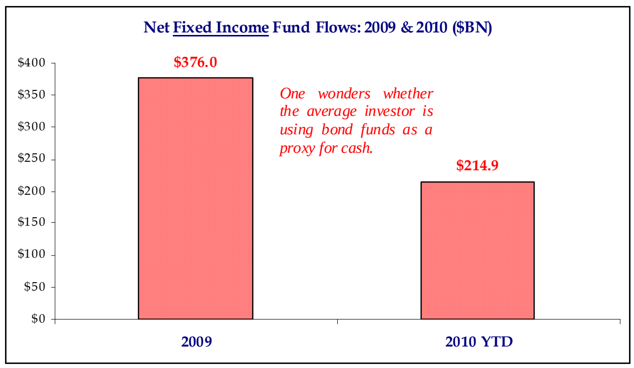

Source: Strategas Research

It doesn't seem that the extraordinarily low yields prevalent in the bond and treasury markets are important at this time. We have no unique interpretation to explain why these rates are so low other than to point out that investor fears of another major equity market decline probably account for much of this situation. Whether justified or not, the fears are the lingering result of the severity of the most recent recession. Additionally, the absence of any clear signs of a recovery in employment continues to suppress the expectation of a "normal" recovery.

In terms of unemployment, a debate is also forming over the sustainability of future job creation and growth. One side believes that the problem is secular and structural. This suggests that job availability will be limited and any reacceleration of growth will be muted. Conversely, many (including the U.S. Government) believe it has been the severity of the recession and painfully slow recovery that is inhibiting the hiring process. We believe that some truth can be found in both points of view. While we expect an ultimate recovery in jobs in the future, the type of jobs may be very different. With the rise in cheap labor available in China, India, and other Asian countries, the U.S. must find new industries to create sustainable job growth. However, this approach seems to be taking a back seat to another round of economic stimulus led by the Federal Reserve's implementation of "quantitative easing" (open market purchases of U.S. Treasuries). Given that the Fed believes inflation is not an issue, we expect to see another round of monetary stimulus. We take issue with these approaches and would prefer targeted tax relief and investment incentives as a better approach to reigniting economic growth in this country. As an example, spending targeted at new technology and energy programs could ultimately lead to new industries and businesses.

Regardless of how U.S. (and global) economic growth is achieved, the intermediate term direction for our economy is moving slowly in an upward manner. We are not ignoring the two issues that must ultimately be addressed; debt and housing. However, we expect both would improve substantially with a recovery in jobs. We continue to expect a GDP growth rate of 2 – 3% in the coming few years. Corporate profits are expanding, balance sheets are in excellent shape, and global growth is likely to help pull the U.S. economy upward. As more consumers feel that their jobs are secure, we would expect to see a continued increase in consumer spending. Any increase in job growth will likely cause this trend to accelerate.

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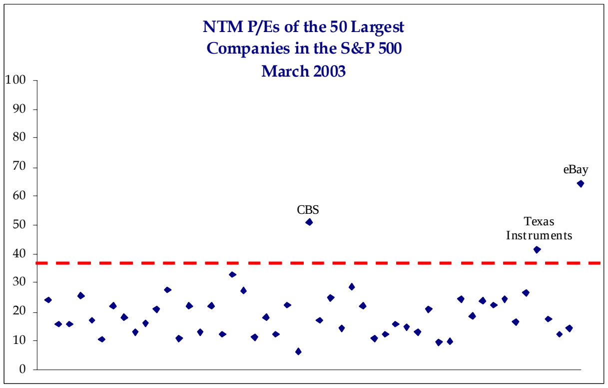
At present, there is also a concern over stock market valuation. Despite the recent recovery in prices, we believe the overall market remains attractively priced. As mentioned previously, investors continue to shun the market which is resulting in valuations (particularly in dividend paying stocks) that look very attractive.



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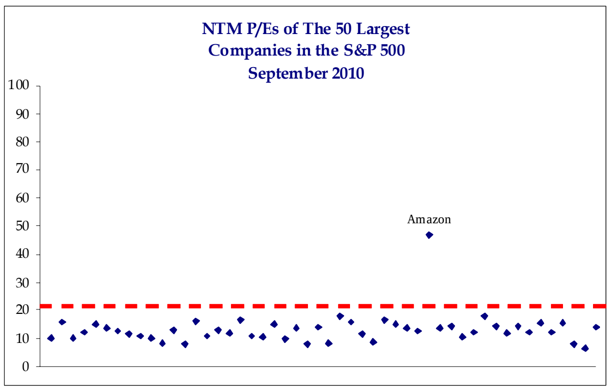

Source: Strategas Research

As the above charts indicate, the current valuation for the U.S. equity market is significantly more attractive than in March 2003, which marked the beginning of a strong recovery in the stock market in subsequent years.

Our strategy for tax adjusted, long-term appreciation in equities has not changed in the last year or so. We continue to seek investments of category dominant companies that would benefit from the ensuing U.S. and global economic recovery. We also remain very sensitive to capital preservation. Should events ultimately unfold that would jeopardize the global economic recovery we anticipate, we will again move quickly to protect the assets of our clients.

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