KERNS CAPITAL MANAGEMENT, INC.

Kerns Capital Management Market Report

February 1, 2010

Clients and Friends,

There is a market phenomenon called the "January Effect". Generally, it is claimed, that if the first 5 trading days of January finish up, the year will finish up. This happens a high percentage of the time. The first five days of 2010 finished up.

This "effect" has been further tracked to show that if the first part of January delivers a strong market, the month will finish strong. The first part of January delivered; unfortunately, the second half did not.

Whereas January experienced one of the strongest starts in many years, the last half of the month delivered a disappointing finish which erased all of the month's gains and more. The market was due for a pullback. We expected it, wrote about it and reacted to it - but it is still disconcerting when it happens.

The question now is: will the year finish up or down? We think it will be up. If you refer to our January 1 letter (available at KernsCapital.com) which tracks bull markets that accompany recoveries from recessions, you will see why. The more urgent question is whether the correction is over or do we have more to follow.

This letter will describe why this pullback has occurred and our opinion on whether the three factors causing it will persist.

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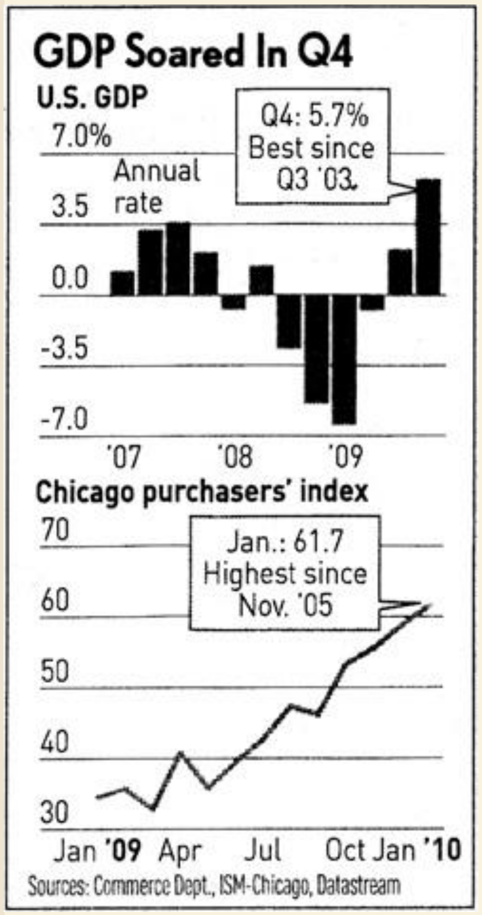
Market Overview

First the Good News

Last week we received news that during the 4th quarter of 2009, the U.S. economy expanded by an annualized rate of 5.7% - the best quarter is almost six years. This was a sharp acceleration compared to the third quarter growth of 2.2% and provided a brighter end to a grim year for the U.S. economy, when output fell by 2.4%, its biggest annual drop since the end of the second world war.

Even though 60% of the gains last quarter came from a potentially temporary factor - the rebuilding of business inventories that had been allowed to sell down to an unsustainable low level during the worst part of the recession - it was just the shot in the arm the economy needed.

There are other positives:



- Non-residential fixed investment grew by 2.9% after tumbling in the third quarter - a signal that companies are beginning to prepare for better times.
- Investment in equipment and software grew by 13.3%.
- The reluctance of business to further reduce inventory, reflects their desire to be ready for increased demand and recognition that they may have cut production too aggressively during the downturn.
- The weak dollar and the global recovery helped U.S. exports increase by 18.1%.
- Consumer spending continues to increase rather than decrease.
- The high increase in U.S. productivity in the fourth quarter - 7% according to JP Morgan economists - could also indicate that companies have squeezed the most out of existing workers and need to start hiring again.

Now the Bad News

Even though bull markets always have corrections on the way up; what causes a market pull back in the face of the good news listed above?

We always need to keep in mind that in many instances, markets just run out of buyers and need to gather some steam before resuming their climb. <u>Almost always, there is some factor or factors that trigger fear in investors when markets reach unfamiliar new highs</u>.

In January's case there were three uncertainties that created head winds:

- <u>U.S. policy uncertainties.</u> Ironically, the only solution for increasing the number of jobs for the unemployed must come from a positive climate for businesses to grow and prosper.

Instead, government seems willing to kill the goose that lays the golden egg. I won't go further with this because I know it is a sensitive issue.

- Sovereign Debt Issues. There are weaker countries such as Greece, Spain, Portugal and Ireland that could potentially default on their borrowings. We are talking about countries defaulting because of irresponsible fiscal policies. Even England is very near having its debt ratings downgraded for overspending. Right now, this fear is causing money to flow into the U.S. and is strengthening our dollar - in spite of the fact that the U.S. is one of the biggest over spenders. In the office, we call the U.S. dollar "the tallest of the dwarfs".
- Unlike the western economies which are suffering, the Asian economies are thriving. They are the one's loaning us the money to overspend. China's economy is so strong that it is beginning to overheat! In order to cool it down, the Chinese government stopped all bank lending in mid-January. This not only cooled down the Chinese economy, but put a chill up the spines of the rest of the world.

You will notice that all of the negatives to the stock markets and your investment portfolios are government issues. I certainly do not have all the answers and I fear most politicians around the world who do have the answers will not have the will or the ability to implement the answers in a timely fashion.

What I am confident about is that if given a chance, free enterprise and our capitalistic economy will survive and thrive.

How Are We Doing?

Whereas our Aggressive model was up 3.81% year-to-date through January 14th while the S&P 500 was only up 2.81%, both finished January lower. We ended the month slightly lower than the S&P 500.

The major reason we were ahead at mid-month is the same reason we were behind at the end of the month. We have strong positions in materials and energy companies. For many months there has been strong demand for commodities and they have been steady performers, fueled by China's insatiable appetite to grow their economy. We believe commodities will continue to show strong growth while the world economic recovery progresses.

We think that the correction in commodities will end when China resumes lending which they must do in order to sustain eight to ten percent growth annually. Their problem is a success problem, not a recessionary problem.

We also feel that when it becomes clear that the Eurozone is not going to abandon their troubled partners (Greece, Spain, Portugal and Ireland) the U.S. dollar will no longer be needed as a safe haven and will fall. This started today with the Eurozone's announcement that they will force their members to solve their problems even if their respective politicians do not have the will to do so. The dollar fell today.

Both the resumption of lending by China and the Eurozone support for its members will cause the dollar to weaken. This should refuel the demand for commodities and our holdings should bounce back strongly.

Note: For 401(k) plans without self-directed brokerage accounts, please see your Plan's monthly

Investment Performance Summary for actual performance.

KCM Macro Trends Fund

The **KCM Macro Trend Fund** (KCMTX) ("the Fund") is an out-growth of the model portfolios we have been successfully managing for our clients for more than 15 years. It is a proprietary fund open only to our clients and Investment Advisors (for their clients) via Fidelity, Charles Schwab (**now NTF)**, TD Ameritrade, Pershing, Southwest Securities and Trust Company of America.

For more information about the Fund, including its objectives, strategies and performance, please give us a call at (800) 945-2125, or click on the following direct links: KCM Macro Trends Fund or 2009 4th Quarter Fact Sheet (FINRA reviewed).

In Closing

One thing that makes our business attractive is that it is impossible to bet bored. It is a constant learning process. I ran across this quote by Mahatma Gandhi which is not a bad set of rules to live by:

"Live as if you were to die tomorrow. Learn as if you were to live forever."

Lane Kerns