

OVERVIEW

For the last year, an extraordinarily challenging market environment has resulted in disappointing investment returns for global equity investors. In fact, we are in the midst of the worst domestic equity market in a generation, with the NASDAQ having declined over 60% from its March 2000 peak and the S&P down over 25% during the same period. The last two years have been marked by three interrelated phenomena, which profoundly impacted equity markets. First was a dramatic expansion of the monetary base in response to fears of Y2K uncertainty, followed by a swift reversal in policy, leading to an equally dramatic monetary contraction. Second was the rise and fall of huge sectors of “new economy stocks”, commonly known as dot.com companies. Finally, economic growth has materially slowed as the result of the onset of a textbook business cycle downturn.

MONETARY POLICY: THE FED WHIPSAW

In the latter stages of 1999, the Federal Reserve grew the monetary base at an 18% annualized rate in response to the unrealized Y2K “threat”. The Fed’s excessive injection of capital into the system precipitated a modern day tulip bulb craze, inflating the values of dot.com companies. Capital was freely available to the Wall Street selling machine. Waves of unproven companies with no real economic underpinnings such as positive cash flow, earnings or sound business models were brought public and promoted to unprecedented valuations. This simultaneously lifted the prices of more established companies throughout the investment spectrum.

This capital surge also had unintended macroeconomic consequences. Given an already strong domestic economy, the free flow of capital created an environment of hyper growth. From the 3rd quarter, 1999, through the 2nd quarter, 2000, US GDP grew at roughly a 6% rate and corporate earnings grew at an approximate 18% rate, roughly double the historical averages.

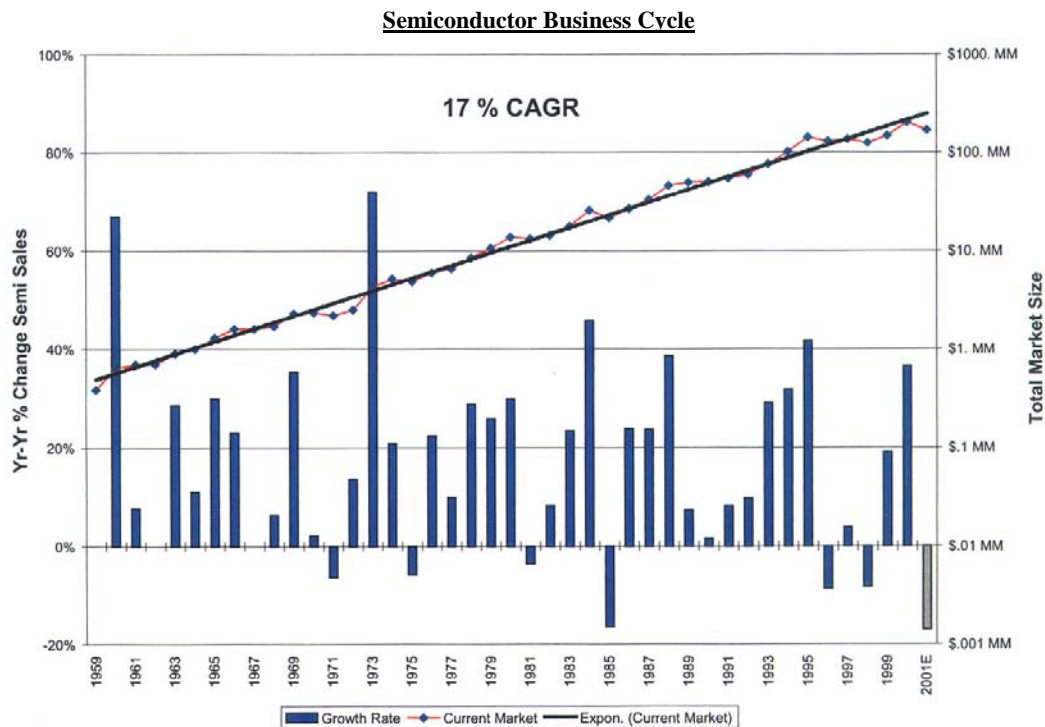
The stimulus to the capital markets caused by exceptionally loose money supply was reversed when the Fed abruptly changed course and hiked rates and drained liquidity. It proceeded to raise interest rates six times from the spring of 1999 to the spring of 2000. The Fed rapidly decelerated monetary base growth from the dizzying peak of 18% annualized growth, to an almost –3% shrinkage in the second half of calendar year 2000. This is akin to taking a sports car out on the highway, accelerating to top speed and then stomping on the brakes.



ECONOMIC OUTLOOK: RETURN OF THE BUSINESS CYCLE

Economic growth has materially slowed in the U.S. and worldwide, particularly in the manufacturing sector. While the Fed's actions have exaggerated the market and economic swings, the other culprit for the current slowdown is a textbook business cycle downturn. Global industrial and manufacturing businesses (including such Cypress investment sectors as semiconductors, telecommunications equipment and technology hardware) are currently experiencing a fairly dramatic earnings decline directly related to over investment, inventory excesses, pricing pressures, margin erosion and employment adjustments commonly associated with a business cycle downturn.

The Semiconductor Industry Has Shown Remarkable Long-Term Growth



In spite of these short-term hindrances, we believe that the U.S economy remains fundamentally sound and that the Fed is fully engaged in an attempt to rekindle growth in the domestic economy with lower interest rates. This should ultimately lead to renewed earnings growth and stock appreciation. We believe the Fed, having already experienced the repercussions of wild monetary swings, is currently following a more measured and steady approach to monetary growth. Fortunately, the process of building a sustainable recovery has already begun; however, sustainable recoveries take time. Notably, since World War II the United States has experienced nine bear markets and nine recessions, of varying duration. Despite these periods of extreme economic and market upheaval, real GDP has expanded 3.5% yearly and large-cap stocks have returned 13.4% annually¹.

¹ Ibbotson Associates



At the government policy level, interest rates must continue to decline and tax levels must be reduced to encourage savings and investment. At the corporate level, balance sheets must be repaired, excess capacity must be remedied, business rationalization through layoffs and mergers must continue and demand must eventually turn up. At the investor level, confidence must return. We believe these processes are currently well underway and, while the timing is uncertain, a market recovery later this year should anticipate the ensuing recovery in the economy and corporate profits. Our efforts in the face of the current downturn - prune weaker holdings and focus the portfolio in the higher quality issues - are largely complete. Within the sectors most affected by the business cycle, we believe that patience in anticipation of the inevitable upturn is warranted.

CONCLUSION: STAY THE COURSE

Unlike the period of the 1970's and early 1980's, inflation is well under control, interest rates are low, and American industry remains the clear leader in global growth markets from technology to financial services to health care. Moreover, the economic benefits of the technology and communications revolution remain alive and will continue to drive long-term growth and productivity.

The stock market reflects a continual struggle between fear and greed. The Internet mania and other excesses of the late 1990's have given rise to the extreme pessimism of the current market. Just as the market enticed everyone to join in at the height of the Internet bubble, it now conspires to scare everyone out of stocks at prices down 25 to 75 percent. We advise our clients and all long-term investors to stay the course, fortified by a diversified portfolio of high quality leadership companies. Your portfolio represents a strong platform for future growth and most of our companies will emerge from the current downturn in a stronger market position.

