

**C Y P R E S S**  
ASSET MANAGEMENT, INC.



**MARKET COMMENTARY**

**April, 2005**

Despite a slow start to the year, with all major U.S. indices down for the quarter and the S&P 500 declining 2.6%, we believe 2005 will ultimately prove a good year for stocks based on solid earnings growth and reasonable valuation levels. The S&P 500 currently trades at 16 times estimated 2005 operating earnings, providing an “earnings yield” of 6.25%. This compares favorably to bonds, where the 10 year U.S. treasury yields only 4.5%. In very basic terms, the S&P 500 is still almost 24% below its March 2000 peak while corporate profits are at a record high and more than 20% above their level in March 2000. Earnings are strong, of high quality, and growing while PEs are down considerably, making for an attractively valued market. We expect the U.S. economy to continue to grow in a range of 3% to 4% for the next few quarters, strong enough to support continued earnings growth but not so strong as to require the Fed to aggressively raise rates and

over tighten. We believe the pace of economic growth is likely to slow in the second half of the year, and that the equity and bond markets will react positively to news of slower growth. Evidence of slower economic growth should alleviate fears of a sharp rise in interest rates and also help moderate oil prices, two major concerns in the current market, setting the stage for a decent rally in the second half of the year.

In this environment of slowing but stable growth, high quality large cap growth stocks should perform well. Our companies are benefiting from strong cash flows and liquidity, which is being returned to shareholders through dividend increases and share repurchases. This provides a solid long term basis for a very attractive total return. Below we review our updated Market Balance Sheet, which remains generally positive for equities.

**Market Balance Sheet**

POSITIVE	NEUTRAL	NEGATIVE
Interest Rates Economic Growth/Industrial Production Fiscal Policy Economic Growth/Consumer Spending Valuation Profit Growth/Margins Productivity Demographics	Free Trade/Protectionism Dollar Inflation Employment	Budget Surplus/Deficit Geopolitical Stability Energy Prices Liquidity (Monetary Growth) Regulatory Environment

## **POSITIVE**

Interest Rates	Still historically low and favorable to equity valuations; while the Fed Funds rate is likely to modestly rise from the current 2.75% to 3.50% in 2005 (assume 3 more 25 bps Fed raises), we still see an accommodative Fed. A gradual rise in rates is actually a positive signal confirming an ongoing economic expansion. We will be watching the dollar, as further declines could pressure the Fed to raise short term rates more than desired.
Economic Growth	Should remain in a healthy 3%-4% range for the next few quarters. <ul style="list-style-type: none"><li>➤ Profits and corporate liquidity are surging, providing the foundation for the next stage of expansion: increased business investment and higher employment; and, for shareholders, a period of rapid dividend growth and share repurchase.</li><li>➤ The economic growth driver has shifted from the consumer to capital spending and industrial production, and toward innovation, small business, and more entrepreneurial activity.</li></ul>
Fiscal Policy	Taxes on dividends and capital gains at lowest levels in over 60 years, not in jeopardy of change prior to 2009. Bush will push hard to make the tax cuts permanent.
Productivity	Continues to drive profit growth and keep the U.S. economy the most competitive in the world; will moderate somewhat as economic expansion lengthens and we move closer to full employment.
Profit Growth/ Margins	Strong, but profit growth will moderate to 6%-10% range during 2005; profit margins at high levels and supported by continued gains in productivity.
Demographics	Baby boomers in the sweet spot of wealth and investing cycle, hungry for growth and income.
Valuation	Reasonable at 16 times estimated 2005 S&P 500 operating earnings, leaves some cushion for a continued moderate rise in rates. Moreover, stocks are significantly cheaper than bonds, where the bellwether 10 year treasury currently yields only 4.5%, and is thus valued at roughly 22.5 times “earnings” (its coupon).

## **NEUTRAL**

Inflation	Remains low, but over the last year and a half we have seen significant increases in the price of global commodities and industrial materials – worth monitoring. China remains the dragon slayer of inflation, exerting downward pressure on U.S. wages and manufacturing.
Dollar	The trade weighted dollar has declined about 25% over the past three years, but actually strengthened during the first quarter. A return of dollar weakness, however, could lead to higher short term interest rates in order to lend support to the dollar. The weaker dollar helps U.S. multinationals, but our trade deficit remains stubbornly high despite the competitive advantages of a lower dollar. It is also worth noting that about 30% of our trade deficit is due to imported oil (net energy imports are currently running at an annual rate of around \$180 billion). This is a structural deficit, which has exploded in the last couple of years due to the declining dollar and doubling of global oil prices.

Free Trade/  
Protectionism Muddled state of affairs; a more concerted free trade policy out of both U.S. and Europe would be positive for global growth; “outsourcing” issue a political red herring (remember the U.S. economy is the primary beneficiary of global growth).

Employment Nineteen consecutive months of job growth reflect a steadily improving employment picture, and the 5.2% overall unemployment rate is relatively low by historical standards. Employment growth has been less robust than in typical recoveries, and the pace of job growth is likely to moderate further over the course of the year.

### **NEGATIVE**

Budget Deficit A concern at 3.5% of GDP but in an improving trend. Would like to see more spending restraint in 2005. Bigger issue is the persistent growth of medical care costs and the long term liability of retirement in our aging society. Debate over social security reform is at least a start.

Energy Prices Oil is likely to remain in a \$40-\$55 price range for some time. Without a global economic slowdown, it is difficult to make a convincing case for a collapse in energy prices. While high energy prices act as a drag on the global economy, on an inflation adjusted basis, oil prices are still well below the peaks seen in 1980 and 1990. We continue to find the sector attractive from an investment standpoint.

Liquidity  
(Monetary Growth) Money growth has slowed and is below levels of nominal GDP.

Geopolitical  
Stability Perhaps with successful elections, Iraq has turned the corner; but terrorism threat will be with us for some time. Although event risk remains significant, investors are becoming more accustomed to dealing with terrorism, scandals and unforeseen events.

Regulatory  
Environment Federal and state investigations continue to impact individual corporations and entire industries. The pendulum of regulatory scrutiny appears to have swung from pre Enron laxity to downright anti business regulatory and governmental activity. Perhaps 2005 will mark the zenith of regulatory scrutiny and high profile investigations.