CYPRESS

ASSET MANAGEMENT, INC.

MARKET COMMENTARY **July, 2005**

While stock market performance has been subdued thus far in 2005, underlying economic and equity fundamentals remain very solid, increasing our conviction that the markets will rally in the second half of the year. Despite nine rate hikes by the Fed, bond rates are lower now at 4% on the 10 year U.S. Treasury than at the start of the year (4.22%) and lower than a year ago (4.65%) when the Fed began raising rates. Corporate profit growth has slowed but remains quite healthy at about 10%. The combination of a decline in long term rates, continued profit growth, and generally flat stock prices during the first half all contribute to a very attractively valued stock market. The S&P 500 currently trades at 16.5 times consensus 2005 estimated operating earnings, the lowest average annual PE seen in the market since 1995. Moreover, relative to bond yields and still lower short rates, stocks are unusually attractive compared to fixed income investments.

We continue to expect somewhat slower economic growth in the second half of 2005 due to both Fed tightening and the continued rise in oil prices. But the good news is that while high energy prices and rate increases have already begun to slow the economy, we believe the Fed is near the end of the current cycle of rate hikes and should be finished in the second half of the year after one or two more increases in the Fed Funds rate. On balance, we are now more concerned about the possibility of economic weakness than an overheating domestic economy. The flattening yield curve – higher short rates and declining long term rates – that has developed over the past year indicates both slower future growth and that the Fed has done its job. Were the Fed to over tighten and force an inversion of the yield curve, historically a very good predictor of recession, we would be worried about both the economy and stocks. While a concern and something we will watch closely, we do not expect this to happen. Of note, the strengthening dollar, up over 10% in the first half of this year, helps to slow inflation and alleviates some of the pressure on the Fed to continue tightening. The stronger dollar should also begin to attract more foreign capital to U.S. investments.

We believe slower growth and an end to Fed rate hikes will be viewed favorably by the market. The current economic expansion is now in its third year, and it is natural that the pace of growth should moderate. The U.S. economy continues to perform remarkably well and remains fundamentally very healthy, increasing our long term confidence in equities. We would highlight positive trends such as continued double digit profit growth, 22 consecutive months of U.S. employment growth, the lowest unemployment rate (5%) in 4 years (since September 2001), continued strong gains in productivity, a recovering dollar, and still low and contained inflation (between 2% and 3% by most measures) despite the rise in energy and other commodity prices over the past 3 ½ years. Moreover, foreign economies have slowed over the past few quarters, particularly Europe and Japan, further testing our domestic economy. Slower but stable real economic growth must be seen in this broader context, and represents a sound foundation for equities.

Finally, we have talked a good deal in recent commentaries about the surge in corporate profits and liquidity, and the increasing importance of dividends in the current environment. These trends remain firmly in place for investors. Not only is corporate cash at record absolute levels, but cash as a percentage of assets is at the highest level since the mid 1960s. While dividend growth has been strong (like profits, S&P 500 corporate dividends are also at record levels), there is considerable room for companies to further raise dividends. With a payout ratio of only 29% on the S&P and such strong corporate balance sheets and cash flows, we should see above average dividend growth from our companies for some time to come.

Increased merger and acquisition (M&A) activity is another by-product of robust corporate liquidity, and is running about 25% above year ago levels. All of this liquidity induced activity - dividend growth, M&A, and also share repurchases - should continue to support stocks and enhance investor returns. We continue to focus on dividend growth as both a sign of good fundamentals and as a key component of long term total return. A diversified portfolio of stocks with a growing dividend stream should provide long term returns which will be very difficult for competing asset classes to match.

Market Balance Sheet

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

<u>POSITIVE</u>

Interest Rates — Still historically low and favorable to equity valuations; while the Fed Funds rate is likely to rise from the current 3.25% to 3.75% in the second half (assume 1 or 2 more 25 bps Fed raises), the second half should finally mark the end to this cycle of rate increases. The stronger dollar thus far in 2005 also gives the Fed greater flexibility to end its tightening.

Economic Growth — Should remain in a healthy 2.5% - 3.5% range for the next few quarters.

- Profits and corporate liquidity are surging, providing the foundation for the next stage of expansion: increased business investment and higher employment; for shareholders, a period of rapid dividend growth and share repurchase.
- The economic growth driver has shifted from the consumer to capital spending and industrial production, and toward innovation, small business, and more entrepreneurial activity.

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 7% - 10% range during 2005; profit margins at high levels and supported by continued gains in productivity, but under some pressure from rising energy costs.
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 U.S. Treasury currently yields only 4%, and is thus valued at roughly 2.5 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 20% over the past three years, but actually strengthened about 10% during the first half. 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	Twenty two consecutive months of job growth reflect a steadily improving employment picture, and the 5.0% 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	Still a concern at 3% 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	Up 30% year-to-date, oil is likely to remain in a \$40-\$60 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 over the last year and is below levels of nominal GDP.
Geopolitical Stability	Despite successful elections, Iraq continues to be plagued by terrorism; and the recent London bombings remind us that the global terrorist 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.