C Y P R E S S

ASSET MANAGEMENT, INC.

MARKET COMMENTARY **October, 2005**

Thus far in 2005 the market has shown considerable resilience in the face of a mounting wall of worries. Equities have been caught in a tug of war between rising earnings and declining PE multiples. Strong earnings growth is a reflection of a robust global economy and favorable business conditions while shrinking PE multiples (i.e. valuation) reflect ongoing Fed interest rate increases and a growing list of economic worries. These concerns include: 1) a housing bubble, 2) high energy prices, 3) runaway federal spending, and a resurgence of inflation arising from all of the above. The end result is a nervous stock market fraught with pessimism. The good news is that most of today's fears are priced into the market. As a result of PE multiple contraction, the S&P 500 trades at 16 times 2005 consensus operating earnings – well below the average multiple of the last two decades. In fact, a skeptical and modestly valued market such as we see today is typically a good time to buy stocks, not sell them.

Hurricanes, the Fed, and Inflation

We believe the market is poised to rally when it anticipates an end to Fed rate hikes. But this simple catalyst has proven elusive. As one wag put it, the further the Fed raise rates, the more it seems they have to go. When we finally came to a point late this summer where the Fed might have signaled an imminent pause in its campaign of "measured" rate increase, and taken stock of the impact of 11 consecutive rate increases, along came Hurricanes Katrina and Rita. The hurricanes brought a surge in already high energy prices directly impacting consumer prices for gasoline, natural gas and heating oil, along with the prospect of massive federal spending to rebuild New Orleans and the Gulf Coast. These new fiscal demands come at a time when our federal budget is already sorely stressed by the global war on terror and Iraqi reconstruction, coupled with unabated growth in federal domestic spending. These events conspired to raise inflation expectations, and the Fed understandably decided to march on with its' campaign of "measured" tightening.

But investors should not lose heart, all is not lost. We do not believe that high energy prices and elevated federal spending will lead to anything more than a temporary rise in the inflation rate. Despite the rise in energy prices over the past two years, inflation has remained well contained as measured by the PCE Core Price Deflator, currently running at just over 2%. This measure is closely followed by the Fed, and has been consistent with the CPI and other inflationary measures. Inflationary expectations, however, as measured by the Conference Board and others, have risen in the aftermath of Katrina. They indicate the possibility that inflation could temporarily rise towards the 4% level a year out, but also show it again subsiding to the 2% trend line further out.

What gives us confidence that inflation remains fundamentally low and well contained? Today's global economy exerts relentless competitive pressure on prices, whether the competitive source is from China in manufacturing, India in services, or Eastern Europe in both. Note also that the equity markets seem a lot more concerned about inflation than does the bond market. Long term bond rates remain quite low by historical standards. Low bond yields are a global phenomenon. For example, amazingly, Canada, China, Italy and the Czech Republic all have bond yields below the current 4.35% level of the 10 year U.S. Treasury bond. Global

economic forces strongly support continuation of the current low inflation environment.
Finally, slower economic growth in future quarters should reduce inflationary pressures. U.S. GDP has been a steady 3% - 4% for seven consecutive quarters, but is likely to moderate to a 2.5% - 3% range for the next few quarters. A mid cycle slowdown – a pause that refreshes in an ongoing, durable economic expansion – is typically good for stocks and for the inflation outlook. This period of slower growth is still enough to sustain 5% - 7% earnings growth next year, but a moderating economy with reduced inflationary pressure should allow the Fed to quit tightening and even to ease rates if needed sometime in 2006. Slower growth should actually prove the right tonic for both the market and the Fed.

Stocks and Chicken Little

While stocks have shown resilience given the headwinds discussed above, stock price appreciation has lagged earnings growth over the last two years. Corporate earnings are up about 34% since the start of 2004 while the S&P 500 is only up 11% over the same period. Not only are stocks cheaper than they have been in some time, but they are attractively valued when compared to competing investments in bonds, cash or real estate. Money market rates remain low and the 10 year treasury yield is well below its historical average. The housing and real estate markets have greatly benefited from these same historically low longer term interest rates, and have experienced significant appreciation and money inflows over the past few years. Thus stocks have meaningfully lagged not only their own earnings growth rate, but also bonds and real estate over the past few years. Stocks today offer the potential for good absolute and relative returns, yet they remain decidedly unloved. The current negative sentiment and wall of worry will likely prove a good opportunity for patient investors. Undoubtedly, things can go wrong in the world and cause harm to the equity market, such as recession, recurrent inflation, or acts of global terror. We all fear that Chicken Little could be right one day, but until then stocks appear a pretty good place to invest for the future.

Market Balance Sheet

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

POSITIVE

Interest Rates — Still historically low and favorable to equity valuations. Inflation expectations have risen with the spike in energy prices and increased federal spending due to hurricane Katrina and rebuilding of New Orleans, which has kept the pressure on the Fed to continue rate hikes. While the Fed Funds rate is thus likely to rise from the current 3.75% to 4.25% (assume 2 more 25 bps Fed raises), we should finally be nearing an end to this cycle of rate increases.

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, but this is made more difficult by the near term surge in Federal spending (Katrina, Iraq with no offset from reductions in domestic spending) and concerns over budget deficit.
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 4.3%, and is thus valued at roughly 23 times "earnings" (its coupon).
Profit Growth/ Margins	Strong, but profit growth should moderate to 5% - 7% range during 2006; profit margins at high levels and supported by continued gains in productivity, but under some pressure from rising energy costs.
Productivity	Continues to drive profit growth and keeps the U.S. economy the most competitive in the world; will moderate somewhat as economic expansion lengthens and we move closer to full employment.
Demographics	Baby boomers in the sweet spot of wealth and investing cycle, hungry for growth and income.

NEUTRAL

Inflation	Remains low, but inflationary pressures are building near term. Hurricane related surge in gasoline, heating oil and natural gas prices from already high levels is a challenge, as is the huge cost of rebuilding New Orleans and the Gulf Coast. Lack of fiscal discipline was already a concern – the war on terror and Iraq reconstruction coupled with high levels of domestic spending – even before September hurricanes. Still, we believe higher inflation will prove temporary, as the Global Economy exerts relentless pressure on prices. In particular, China remains the dragon slayer of inflation, exerting downward pressure on U.S. wages and manufacturing. Low global bond yields (rates in Western Europe, Canada, even China and the Czech Republic are all below the U.S. ten year bond) also indicate inflation remains well contained.
Dollar	The trade weighted dollar has declined about 20% over the past three years, but actually strengthened about 11% year to date. 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 $200 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.

Employment	Twenty seven consecutive months of job growth came to an end in September due to hurricane Katrina related job loss, but the employment picture remains quite healthy. The 5.1% 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.
Free Trade/ Protectionism	Free trade and free market oriented reforms were given a recent boost by election results in Japan and Germany. CAFTA also a nice positive for increased free trade in the Americas.

NEGATIVE

Budget Deficit	Still a concern at 3% of GDP but was in an improving trend before hurricane Katrina. Would like to see more spending restraint in 2006. Tough to rebuild Iraq and New Orleans at the same time, but need for spending discipline has at least been recognized in Washington. 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 was at least a start, but has lost political momentum.
Liquidity (Monetary Growth)	Money growth has slowed over the last year and is below levels of nominal GDP, but there are some signs it is turning up.
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.
Energy Prices	Up 34% year-to-date, oil is likely to remain above $40 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 below the 1980 peak. We continue to find the sector fundamentally attractive from an investment standpoint.
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.