CYPRESS
ASSET MANAGEMENT, INC.

MARKET COMMENTARY **July, 2006**

Despite a lot of sound and fury during a volatile second quarter, we reached the half way mark in 2006 with the S&P 500 having inched upward some 2% from where it started the year. Both the U.S. and global economy continue to show an impressive underlying strength and resilience in the face of high energy prices, rising interest rates, and a slowing domestic housing market. The surprising strength of the global economy in the first half has been accompanied by a surge in commodity prices from oil to copper and gold. This, in turn, has led to growing concerns over inflation. In response to rising inflation expectations, the Fed, and more recently, other central banks around the world have raised interest rates.

All of these forces, high oil prices, higher interest rates (but keep in mind that longer term rates are still well below historical averages both in the U.S. and abroad), and a weaker housing market should slow the economy in the second half of the year. As we have discussed before, a mid cycle slowdown is typically good for both stocks and the inflation outlook, and serves to prolong an economic expansion.

Inverted Yield Curves, Inflation and Hot Commodities

We exited the first half with a classically flat to inverted yield curve – short rates as high or higher than longer term rates. This is generally considered to be an indicator of a slowing economy and a peak in the Fed funds rate, signaling that the next move in rates is likely to be down. Barring a further rise in inflationary pressures the Fed has done its job at a 5.25% fed funds rate, and perhaps even gone a little further than necessary. The issue of inflation, while of importance to stock valuations, perplexes both economists and financial markets. We continue to believe the global economy and the increasing importance of the low cost BRIC (Brazil, Russia, India, and China) economies should contain periodic cyclical outbreaks of inflationary pressure.

In our global economy, most markets are highly competitive in terms of both demand and supply. This does not mean inflation cannot break out in a given market for a period of time. The current price spike in commodities has been driven by strong demand from the BRICs pushing overall demand for many basic resources to the point that we are now bumping up against the limits of global supply. Over time we should see supply expand and, in some cases, substitution. As a result, commodity prices should pull back to more normalized levels.

This Is Not Your Father's Global Economy

Thus, unlike what occurred in the late 1970's and early 1980's, we see the current bout of inflation as short lived. In the earlier period we operated in the Cold War economy – a bipolar, more closed system – and we compounded the rise in oil and commodity prices with policy mistakes (gasoline price controls, rent control, high marginal and investment tax rates).

Fortunately, the picture today could not be more different. We have a robust, mostly open global economy, pro growth tax rates and have thus far refrained from price controls. In the late 1970's the spike in oil prices quickly spread throughout a stagnating domestic economy, and the U.S. endured a painful period of stagflation. This time, some two and one half years into a powerful rise in oil and commodities, core inflation remains at reasonable levels (e.g. the Core Price Consumption Deflator favored by the Fed is still running around 2%). Pricing pressures have been largely contained to basic materials and have not spread throughout the economy. Moreover, the U.S. and global economy, despite dire predictions, continue to exhibit strong growth and productivity.

Market Overview

We believe the market is fundamentally well positioned for a good second half. If the S&P 500 rises in line with anticipated growth in corporate earnings in 2006 it would end the year up 9% - 10%. The first half has followed an all too familiar pattern, double digit earnings growth but low single digit returns in the U.S. equity markets. In fact, second quarter 2006 should mark the 12th consecutive quarter of double digit earnings growth for S&P 500 operating earnings. Since 2003, operating earnings for the S&P 500 are up about 50% while the S&P 500 Index is only 15% higher. Fortunately dividend growth has been almost as strong, up 12% year over year thus far in 2006 and up about 40% since 2003. Moreover, with an S&P 500 payout ratio (dividends as a percent of total net profits) of just 30% - well below the 45 year average of almost 50% - there is a lot more room for dividends to grow.

The good news in a sluggish equity market is that stocks today represent very good value at roughly 15 times consensus estimates for 2006 operating earnings. Yet, investor sentiment remains subdued to downright nervous. For the patient investor willing to look past the day to day volatility and litany of worries, stocks should prove a rewarding investment. Today's prices may even look like a downright bargain a few years down the road.

Market Balance Sheet

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

POSITIVE

Interest Rates — Still relatively low and favorable to equity valuations. Inflation expectations have risen but remain contained despite the spike in energy prices and outlook for increased federal spending. Also of note is the inverted yield curve with long rates below the 5.25% Fed Funds rate. While the FOMC could possibly raise rates one more time, we are near the end of this cycle of rate increases.

Economic Growth	Should moderate but remain in a healthy 2.5% - 3.5% range for the next few quarters. ➢ Profits and corporate liquidity are surging, providing a strong foundation for 1) increased business investment and higher employment; and 2) 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. Two year extension of the tax cuts on dividends and capital gains through 2010 is a big positive for equity markets.
Valuation	Very reasonable at 15 times estimated 2006 S&P 500 operating earnings. Moreover, stocks are significantly cheaper than bonds, where the bellwether 10 year U.S. Treasury currently yields 5.15%, and is thus valued at roughly 19 times "earnings" (its coupon).
Profit Growth/ Margins	Profit growth should moderate to 7% - 10% range during second half 2006; profit margins at high levels and supported by continued gains in productivity, but under some pressure from rise in 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

Liquidity (Monetary Growth)	Money growth has picked up in recent months, but still running at levels just below nominal GDP.
Inflation	Remains low, but cyclical inflationary pressures are a concern. We believe any pick up in 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) and a slightly inverted yield curve in the U.S. also indicate inflation is contained.
Dollar	The dollar has stabilized, but a return of dollar weakness 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 $300 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	The employment picture remains quite healthy, with 37 consecutive months of job growth. The 4.6% overall unemployment rate is low by historical standards, and the lowest since mid 2001. Still, 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 boost by recent election results in Japan, Germany, Canada and Mexico.

Budget Deficit

Still a concern at about 2.5% of GDP, but in an improving trend due to surge in federal tax receipts. Would like to see more spending restraint, 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.

NEGATIVE

Geopolitical Stability

Despite successful elections, Iraq continues to be plagued by terrorism. 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

Despite a big decline in natural gas prices, crude oil prices remained strong and finished above $70 in the second quarter. 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 have only recently moved above the prior 1980 peak (corresponds to roughly $66 price today). 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. Nasdaq stocks in particular have been impacted by recent investigations into stock option grants. But perhaps we have passed the high water mark of regulatory scrutiny and high profile investigations.