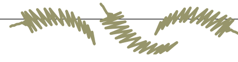
C Y P R E S S

ASSET MANAGEMENT, INC.



MARKET COMMENTARY **October, 2006**

The markets are going through a transition as the economy downshifts from rapid to moderate growth. While the S&P 500 is now up 7% year to date, stocks have been volatile as investors struggle with the implications of slower growth and debate the likelihood of a hard versus soft landing for the economy. Despite the onset of a mid cycle slowdown, we believe economic fundamentals remain solid. After twelve consecutive quarters of robust growth, in which U.S. GDP increased at an average rate of 4% per quarter, it is inevitable and desirable that growth slows over the next few quarters. As we have discussed before, the impact of a mid cycle slowdown is typically salutary for both the economy and for stocks. We believe inflation and interest rates have likely peaked and are headed lower, while recession remains only a remote possibility. This provides a basis for both higher PE multiples for equities and ultimately a reacceleration in growth looking out a few quarters.

The Big Story

The big story for investors continues to be a global economy driven by the growth and industrialization of China, India, Eastern Europe and the developing world. We are in the midst of a powerful long term trend that has thus far proven resilient to high energy prices, a rise in interest rates, and geopolitical tensions. We believe the long term picture is very bright for the global economy and for equities so long as a minimum level of geopolitical stability can be maintained in the world.

A Word About The Portfolio And Energy And Infrastructure

Given our belief that we are in the midst of a historic global economic boom, we have maintained a significant weighting in energy and global infrastructure stocks. These sectors were particularly volatile in the third quarter and will continue to be so until fears of a global recession recede. We believe that so long as the global economy remains healthy – and at this point economic fundamentals remain firmly weighted to the positive side – high energy prices are likely here to stay. Increasing global demand for fossil fuel, driven by China and the developing world, has closed the gap with available supply to the point that we have a tight market with little spare capacity. We are not in the camp that view supply as chronically constrained, but we believe that incremental supply must largely come from non conventional hydro carbon sources. The problem, as "Peak Oil" proponents point out, is that most of the easy oil has been found; so future growth in conventional oil and gas production is very limited. In order to meet the steady rise in global demand, growth must come from non conventional hydro carbons such as the Canadian Tar Sands and other heavy oils,

ultra deep water drilling, and new conversion processes like coal to liquids (already being adopted in China and by U.S. military, among others). Alternative energy solutions such as wind power and biofuels may also play a role.

However, in order to be economically viable, most non conventional hydro carbons need a sustained $45-$50 price in conventional crude oil. Given a healthy global economy, we believe $45-$50 represents a reasonable, fundamental floor for oil prices. The market, due primarily to concerns over a decelerating economy, is discounting energy prices that are actually below the fundamental base range discussed above. We continue to find considerable long term value in select energy firms ranging from domestic coal companies to oil and gas producers and the related service and infrastructure companies that enable the exploration, production, processing, transport and storage of both conventional and non conventional hydrocarbons.

Market Balance Sheet

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

POSITIVE

Interest Rates — Still relatively low and favorable to equity valuations. Inflation expectations 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. We believe that the next move by the Fed will be to lower rates, probably toward the middle of next year.

Economic Growth — Should moderate but remain in a healthy 2 - 3% 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 4.64%, and is thus valued at roughly 21.5 times "earnings" (its coupon).

Profit Growth/ Margins	Profit growth should moderate to 5% - 7% range over the next few quarters; profit margins are at very 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 matures 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.
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. It is 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 40 consecutive months of job growth. The 4.6% overall unemployment rate is low by historical standards, and the lowest since mid 2001.
Free Trade/ Protectionism	Free trade and free market oriented reforms were given a boost by recent election results in Japan, 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. Will we ever see spending restraint 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	Both oil and natural gas prices declined significantly in the third quarter. Without a global economic slowdown, however, it is difficult to make a convincing case for a collapse in energy prices.
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.