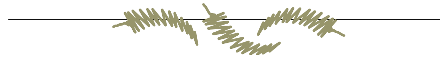
C Y P R E S S

Asset Management, Inc.



MARKET COMMENTARY **January, 2008**

The S&P 500 managed to post a modest return of 5.5% in 2007, despite a difficult second half of the year. This marked the fifth consecutive year of market gains. We are also pleased to report another year of solid performance at Cypress, as our Core Growth Portfolio has now outperformed the S&P 500 over the past 1,3,5, and 10 years. That does not happen every day; we are proud of that record and deeply appreciative of the trust and confidence that all of our clients have placed in us over the years. But last year's performance is history now, 2008 is a new year, and it is not shaping up to be an easy one.

2008 Outlook

As we begin 2008, the market continues to be troubled by fears of recession. It has become the consensus view that the U.S. is already, or will be shortly, in a recession. The major problems confronting our economy are well known and widely discussed (in fact, along with the Presidential election campaign, they dominate our news): a historic housing downturn leaving us with home price deflation and a huge inventory of unsold homes; the associated sub-prime mortgage bust and contagion which has spread into a full blown financial crisis; and a weakening U.S. consumer.

While these problems are well known, the extent, depth and duration of these problems is still unknown. This uncertainty causes a great deal of market angst. A five year consumption and credit binge has left us with a nasty hangover, and we will be some time mopping up the housing mess and unwinding the bewildering array of dumb loans extended and creatively packaged by the financial sector.

But all is not gloom. There are some important positives in both our economy and stock market, and these factors are largely overlooked in the current pessimism. Perhaps most importantly, the problems at hand are identified and we are very focused on solving them and limiting their impact in the economy. The threat to our domestic and global economy posed by the housing and credit crises now has the full attention of the Fed, the Administration and Treasury Department, and, significantly, major central banks around the world. We tend to be pretty good at solving problems once we identify them and bring both a sense of urgency and our considerable resources to bear in addressing them. (It is typically the things that nobody is worried about or expects that have the greatest lasting impact on markets. So called "Black Swan" events like September 11, 2001, the sudden oil shocks of the 1970's, or of a positive nature, the recent spread of free market principles and values to the developing world.)

After a period of fits and starts during last summer and fall, the Fed has fully turned the corner and is now committed to do

whatever it takes to solve these problems and protect our economy. In this regard, on January 10, 2008, Ben Bernanke, Chairman of the Federal Reserve, stated:

> We stand ready to take **substantive additional action as needed** to support growth and provide adequate insurance against downside risks….and prepared to act in a **decisive and timely manner**.

We believe the Fed will cut rates by 50 basis points in January, and ease two or three more times during the year. Fed funds could go as low as 3% in 2008.

The level of cooperation and coordination between the world's central banks is also encouraging and should not be underestimated. Not just the Federal Reserve, but the European Central Bank, the Bank of England, and the Bank of Japan are all injecting massive liquidity into the banking system and working together to address the credit crisis and threat to global growth. Foreign investment capital is also pouring in to participate in the recapitalization and restructure of major U.S. and global financial institutions. Citigroup, UBS, Merrill Lynch, Morgan Stanley, and Barclays PLC have all received substantial investments and capital injection from foreign investors.

So, in summary, these issues will be with us for some time to come, but they have our full and urgent attention. Our financial markets and its major institutions should emerge chastened but wiser, slimmer but more productive and better focused, well capitalized, and prepared to accept slower growth in return for sound risk management.

A Tale of Two Markets: January 2000 and January 2008

If we contrast our current market to the market of January 2000, we find two very different situations. As we began 2000, optimism was rampant and it was generally believed that there were no significant fundamental problems in the economy or the market. We lived in a benign post Cold War world of peace and American hegemony. The internet and broadband promised to revolutionize the way we lived and worked, as well as the composition of American industry and the S&P 500. Military spending seemed anachronistic. The S&P 500 in January 2000 traded at a 29 PE multiple, roughly double that of today. The dividend yield on the S&P 500 was half that of today (1.1% versus 2%) and dividends were considered largely irrelevant to equity returns. The mood of investors was euphoric and indeed the market enjoyed a strong opening quarter in 2000. We all know the rest of the story: one unexpected turn followed another from implosion of the internet bubble to 9-11 to recession to war in the Middle East to the return of the old economy, basic industry and hard assets.

Today the mood is far from euphoric, in fact by some measures market sentiment is at extreme low levels. The State Street Investor Confidence Index recently fell to its lowest point since its inception in the mid 1990's (in January 2000 it was 1% from its all time high). Remember, in the perverse world of the stock market, pessimism and negative sentiment are considered a bullish indicator for stocks. Current equity valuations are also statistically cheap, with the S&P 500 PE ratio near a 20 year low. The S&P 500 trades at a little less than 15 times estimated 2008 operating earnings, which are forecast to grow at only a 4 or 5% rate this year.

One valuation measure, the IBES Valuation Model (the Institutional Broker Estimate Survey relates forward earnings and the current earnings yield of the S&P 500 to the yield on the 10 year treasury bond) is at an all time record low of 48% below fair value. The IBES model has a 28 year track record and reached a peak of 60% above fair value

in early 2000 at the height of the internet bubble.

Conclusion

We are concerned, like everyone, with the formidable problems which confront our economy and our credit markets. There is risk to even our conservative outlook for 1% to 2% GDP growth and 4% - 5% earnings growth in 2008. These are not inspiring numbers, but they are achievable and would ultimately be viewed favorably by the market. We believe the U.S. economy will also exit the year on a much stronger note. As we write, the market is frightened, and we are in the midst of a financial crisis and mid cycle economic slowdown, and most investors seem to be running from stocks. The market is also cheap. The Fed is cutting rates, and is poised to cut even more aggressively. These are the ingredients for a surprisingly good year in equities. But buckle up, just the same, it may be a rough ride.

The Declining Dollar and the American Manufacturing Renaissance

Nor is everything a picture of gloom in our domestic economy, a real bright spot exists in U.S. industry and manufacturing. Contrary to all the hand wringing we hear over the decline in the U.S. dollar, there are a number of benefits to a weaker, more competitive American dollar. The decline in the dollar over the past five years, combined with solid productivity gains in manufacturing during the past decade, has produced a renaissance in U.S. manufacturing. Strength across our domestic manufacturing industries also has the potential to be a significant offset to weakness in the housing and consumer sectors; and we are only in the early stages of this renaissance story. To understand why, we need to step back and review a little recent history and economic theory.

Contrary to what we often read in the newspaper, the U.S. dollar is not in a crisis and has not collapsed. It has merely returned to a more realistic and fair value. From 1995-2002 the dollar surged 30% on a trade weighted basis. A super strong dollar was one of the factors behind our consumer spending and import boom. The American consumer has been the engine of growth for the world economy, our trade deficit ballooned, and foreign economies have experienced a boom in their manufacturing sector – all abetted by the tail wind of a strong dollar. We all knew that was unsustainable.

The dollar began to decline in 2002 and is now down roughly 25%, right back to where it was in the mid 1990s. However, due to the substantial lag effect of currency moves (the so called "J-curve" effect) we are still in the early stages of its boost to U.S. manufacturing competitiveness and exports. A Merrill Lynch study concluded that the competitive benefits of a weaker dollar and the U.S. manufacturing renaissance is in its infancy and will continue for many years. The lags between dollar movements and the peak impact on external trade can be as long as five years (hence the shape of the J-curve: a trade balance initially deteriorates due to more expensive imports and lower priced exports, before demand changes in response to the new currency price and results in rising exports and reduced imports, and the trade balance turns up). This is a story with legs.

The impact on the global economy should also be salutary – a better balanced global economy not so reliant on U.S. consumption and corresponding huge capital inflows. The world's emerging economies need to ultimately develop their own internal demand side, instead of relying on U.S. demand to grow their economies and employment. Nor can we continue to rely on massive foreign funding to support our

consumption. The return of manufacturing in America and weaker dollar should help to redress a number of the imbalances in the world economy and result in a more balanced flow of trade and capital. The strong global economy of today is an ideal time for this transition to begin.

Merrill Lynch argues that U.S. manufacturing cost competitiveness is now at its strongest position in three decades. U.S. manufacturing now enjoys an unprecedented 30% cost advantage vis-à-vis its major trading partners based on relative unit labor costs. The manufacturing revival has not only shown itself in strong outperformance in the industrial sector of the S&P 500 but in the real economy at large:

- Significant recent improvement in the trade and current account deficits. The current account deficit has shrunk from almost 5% of GDP – ex oil – to a six year low of 3%.

- Import substitution. For example, the U.S. steel industry has increased outbound shipments 22% and inbound shipments declined 16% over the same period. Broadly, U.S. manufacturing exports are up 12.4% over the past year and imports have risen only 1.7%.

- Foreign Direct Investment. After being stagnant to down from 2001-2004, foreign direct investment has accelerated sharply in the past few years. Foreign direct investment (in factories and hard assets, not paper securities) rose 16% last year. International companies view the U.S. as a relatively low cost production base – and the capital investments have been very broadly based including technology, electrical equipment, metals, machinery and food.

- The decline in the dollar has been painful for American tourists traveling abroad, but foreigners are now visiting and shopping here in record numbers. Perhaps Mr. Sarkozy came to the U.S. to vacation this past summer not just because of his famous affection for America, but because it was a cheap vacation.

Investment Strategy Implications

We continue to overweight industrial and resource companies that are tied to the global economy and benefit from the weak dollar trend. The domestic macro outlook is downbeat, currently, and the U.S. industrial renaissance is certainly not immune to the housing and consumer downturn. But unless we suffer a bad recession, it should only prove a glancing blow. The longer term trend for the global economy and U.S. industrials remains bright. The fundamental underlying trends of strong growth in the developing economies of the world and the competitive benefits of a cheaper dollar remain in place for some years to come.

Market Balance Sheet

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

<u>POSITIVE</u>

Interest Rates

Low and moving lower; favorable to equity valuations. Inflation expectations are moderating with a slowing economy. Also of note is a yield curve with the 10 year treasury 50 basis points below the current 4.25% Fed Funds rate. We believe the Fed will continue to cut rates in the first half of 2008.

Economic Growth

Should remain positive while moderating to the 1 – 2% range for the next few quarters. We see the odds of a domestic recession as having increased in recent months, but still below 50%.

- Profits and corporate liquidity remain strong outside the housing related and financial sectors and support:
  1) increased business investment and higher employment.
  2) strong dividend growth and share repurchase.
- The housing downturn and the slowdown in domestic economic growth has been accompanied by an increase in defaults in the highest risk mortgage lending area called sub prime loans. There will continue to be losses associated with defaults, foreclosures and asset write-downs, and spill over in the consumer segment of the U.S. economy.
- As we have previously noted, the longer term 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 would likely be threatened by a new administration. There is some talk of temporary tax relief and fiscal stimulus to address the current credit crisis.

Valuation

Very reasonable at about 15 times estimated 2008 S&P 500 operating earnings. Moreover, stocks are significantly cheaper than bonds, where the bellwether 10 year U.S. Treasury currently yields about 3.75%, and is thus valued at roughly 26 times “earnings” (its coupon).

Profit Growth/
Margins

Profit growth slowing to 5% range over the next few quarters; profit margins continue at very high levels aided by ongoing gains in productivity, but under pressure from both a rise in raw material costs and a slower consumer.

Productivity	Continues to drive profit growth and keeps the U.S. economy the most competitive in the world; has moderated somewhat but should reaccelerate due to lower employment growth and a weaker dollar boosting U.S. manufacturing competitiveness.
Demographics	Baby boomers in the sweet spot of wealth and investing cycle, hungry for growth and income.
Liquidity (Monetary Growth)	Money growth is accelerating in the U.S. and global liquidity is very strong. Global broad money (e.g. MZM) is robust, growing at better than 10% on a year over year basis according to ISI Group.

NEUTRAL

Inflation	Cyclical inflationary pressures are subsiding. 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 and a relatively flat yield curve in the U.S. also indicate inflation is contained.
Dollar	The weaker dollar helps U.S. multinationals and exports, but our trade deficit, though improving, 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 represents 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 healthy, with 55 consecutive months of job growth. The 5% overall unemployment rate is relatively low by historical standards, but 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 South Korea, France, Canada and Mexico.
Budget Deficit	Currently running at less than 1.5% of GDP and in an improving trend due to surge in federal tax receipts. Still, we would like to see more spending restraint. Bigger issue is the persistent growth of medical care costs and the long term liability of retirement in our aging society.

NEGATIVE

Geopolitical Stability	Iraq is improving but political progress is still lagging our success in reducing sectarian violence. The global terrorist threat will be with us for some time as will the issue of a nuclear Iran. Although event risk remains significant, investors are becoming more accustomed to dealing with terrorism, scandals and unforeseen events.
Energy Prices	Oil prices rose more than 50% in 2007 and closed the year at about $96/Bbl. North America natural gas prices also recovered from a tough 2006 to finish the year at about $7.50/Mcf, up 34%. Without a global economic slowdown it is difficult to make a convincing case for a sustained drop in energy prices. Additionally, in order to be economically viable, most non conventional hydro carbons (e.g. Canadian Tar sands, ultra deep water, coal to liquids, biofuels) need a sustained price of about $60 per barrel of oil or higher.
Regulatory Environment	Recent changes in Congress and the Presidential election raise the possibility for increased regulation and tax policy changes for certain industries, as well as for individual tax rates.

Cypress Asset Management, Inc.
Core Growth Composite Disclaimer
12/31/1995 – 12/31/2007

	---------Composite Assets--------		---------Total Firm Assets--------					
Year	Beg. Year	End Year	Beg. Year	End Year	No. of Accounts	Year End % of Total Assets	Composite Return	Composite Dispersion
1996	$ 17,340,250	$ 23,862,016	$ 41,874,866	$ 78,978,503	11	30.2%	30.50%	6.39
1997	$ 47,994,149	$ 59,271,588	$ 78,978,503	$ 174,208,080	17	34.0%	26.50%	3.26
1998	$ 71,641,810	$ 87,891,410	$ 174,208,080	$ 259,262,152	24	33.9%	26.21%	3.86
1999	$ 104,987,310	$ 139,052,489	$ 259,262,152	$ 383,940,883	34	36.2%	34.26%	4.41
2000	$ 191,090,022	$ 194,016,705	$ 383,940,883	$ 409,584,980	61	47.4%	-3.13%	2.49
2001	$ 224,505,327	$ 189,498,867	$ 409,584,980	$ 417,594,457	68	45.4%	-12.46%	1.49
2002	$ 189,875,791	$ 152,797,259	$ 417,594,457	$ 290,826,151	72	52.5%	-23.52%	1.95
2003	$ 144,614,841	$ 177,414,761	$ 290,826,151	$ 333,176,142	67	53.2%	25.20%	2.24
2004	$ 168,448,724	$ 170,365,084	$ 333,176,142	$ 356,061,612	62	47.8%	5.38%	1.56
2005	$ 131,509,434	$ 140,940,071	$ 356,061,612	$ 379,521,305	46	37.1%	7.03%	4.08
2006	$ 129,219,746	$ 152,365,928	$ 379,521,305	$ 420,474,602	40	36.2%	14.57%	2.29
2007	$ 150,184,822	$ 152,924,228	$ 420,474,602	$ 487,403,137	38	31.4%	13.60%	4.59

❖ Notes:

❖ Cypress Asset Management, Inc. is a registered investment advisor that invests primarily in domestic equities and fixed income securities for client portfolios. Cypress Asset Management, Inc. is an independent investment management firm based in Houston, Texas, and is not affiliated with any parent organization.

❖ Performance results are calculated gross of (before) investment management fees and net of transaction costs. Cypress' investment management fee schedule is included in Part II of the form ADV. The effect of the deduction of such management fees would have been to reduce the client's return for each period. Adjusting for management fees, the 2007 annual performance would have been reduced from 13.60% to 12.85%. The calculation of performance results uses trade date valuations of securities and reflects the reinvestment of dividends and interest. Results are time weighted. Since February, 1996, composites have been valued monthly and portfolio returns have been time weighted by using beginning-of-month market values plus daily-weighted cash flow. Results before February 1996, were achieved by a prior firm merged into Cypress. In addition to investment management fees, a client's investment return will be reduced by any other expenses related to the management of the account such as brokerage charges, fees or custodial fees.

❖ The equity composite is comprised of discretionary accounts in excess of $500,000 that meet our composite criteria. The composite portfolio includes equity securities that are managed in a group of both taxable and non-taxable client accounts with a view toward capital appreciation. The composite criteria are determined by the Cypress Composite Committee and include: discretionary accounts, fully invested accounts, accounts with an emphasis on large capitalization securities, accounts with a goal of capital appreciation, accounts with a long term investment horizon and minimal cash flow disruption, accounts with no large concentrations of individual securities and accounts with an indifference to tax consequences. In addition, when we undertake management of an account that has securities with a different investment strategy and that has to be transitioned to the Cypress core growth equity strategy, we do not include such an account in the composite until it has been completely transitioned to our strategy.

❖ A complete list of the firm's composites is available upon request. Past market and investment performance is no guarantee of future performance. As with any equity or fixed income investment, there is always a possibility of losses.

❖ Composite dispersion is measured by the range between the highest and lowest performing portfolios that were present for the entire year in the composite.

❖ Composite Assets, Total Assets, Number of Accounts, and Composite Dispersion include portfolios that were present for the entire period indicated.