C Y P R E S S
ASSET MANAGEMENT, INC.

MARKET COMMENTARY **JULY 2012**

The S&P 500 declined 3.3% in the second quarter 2012, as stocks reacted negatively to a steady stream of bad news out of the Eurozone, where its debt crisis seems to be coming to a head, and other macro concerns from signs of stalling growth here in the U.S. to a slowdown in China and other emerging markets. We are by nature conservative investors and have become even more so over the past few quarters in light of the extraordinary challenges in Europe and the mounting uncertainties in the current global environment. We particularly favor the stocks of predictable growth companies in the unpredictable climate. The incremental changes in your portfolio reflect our concern for slowing global growth, a protracted low interest rate environment, and the threat posed by the European debt crisis to the global financial and banking system. We have added to blue chip holdings in the consumer area, particularly in consumer brand staples and consumables but also healthcare. We have also moved to raise the yield and income levels in our portfolios from already above market levels. We strive to maintain a portfolio of high quality assets and durable growth that is well diversified but also strategically balanced and positioned for a rapidly evolving global economy. Your portfolio should continue to produce solid long term appreciation and a reliable and growing income stream.

Global Economic Outlook: Macro Uncertainties And Stimulative Policy Response

With the Eurozone in recession and struggling against itself and its lack of political cohesion to solve its debt crisis, China slowing significantly – not to mention Brazil and India, and the U.S. - going through another summer soft patch, the global economy is now probably the weakest since the recovery began in 2009. The combination of slower growth, Europe's financial crisis, and lower inflation has also led to a significant global easing cycle (both monetary easing and fiscal stimulus). ISI research has counted 203 stimulative policy initiatives announced around the world over the past 10 months.

The European Central Bank, Bank of England, Peoples Bank of China, and the central banks of India and Brazil have all recently cut key interest rates and eased monetary policy in response to slower growth and easing inflation. In the U.S., the Fed continues to be highly accommodative. Central banks and governments are taking action to boost growth, but like oil flowing through a pipeline it takes a while to arrive.

U.S. Fiscal Cliff

While the U.S. economy continues to be in the best shape of all the world's major economies, concern over the "fiscal cliff" looming at the end of this year has started to impact both our markets and the underlying economy. Fiscal Cliff refers to the combination of tax increases and spending cuts scheduled to go into effect the first of next year. If congress remains in fiscal stalemate and does not act before year end, the economy would simultaneously sustain a massive increase in taxes and significant cuts in federal spending. As a result, the Congressional Budget

Office and most private economists project the economy would slow significantly and could go into recession. While we hear much more about the fiscal cliff later in the year, it has already affected confidence and led to greater uncertainty. Many business leaders and economists believe that concern over the tax increases and spending cuts has already begun to impact businesses and consumer spending, causing firms to hold back on hiring and investments.

Market Overview: Stocks Remain Deeply Out Of Favor, Fundamentals And Valuation Are Supportive

Against the gloomy backdrop of global macro concerns and heightened uncertainty (Europe, the U.S. fiscal cliff, cooling growth in China and emerging markets, turmoil and conflict in Iran and the Middle East), U.S. stocks remain out of favor, attractively valued, with strong fundamentals. Most major U.S. companies are in extraordinarily good shape financially and operationally. The bad news is that there really is a lot to worry about, and little certainty about what lies ahead over the next few months. The good news is this is well known and largely reflected in the current stock market.

Stocks continue to be shunned by investors. According to Bank Of America Merrill Lynch, global equity inflows have been less than $1 billion year-to-date, compared to $130 billion for bonds. As a result, corporate bond yields are at record lows (investment grade corporates yield 3.5%) and 10 year U.S. treasuries yield 1.5%. Most measures of investor sentiment are at levels of extreme bearishness, which is a classic contrary indicator and bullish for stocks. Professional investors are also defensively positioned, with hedge funds at historically low levels of market exposure. None of this precludes the market from going lower, but it may limit some of the downside risk.

Dividend Picture: Yields That Can Grow

The dividend story is a significant positive for stocks, supportive of valuation and solid long term returns for investors. S&P 500 dividends are at a record high level, yet the dividend payout ratio is at record low (ISI, BAML). This means there is a lot of room for dividend growth, and in this protracted low interest rate environment, there is little reason for companies to continue to hoard cash. From a demand side perspective, not only do investors crave yield but demographics point to a growing population of investors seeking income. Over the next 12 years, the Census Bureau projects the percentage of the U.S. population older than 65 will increase by almost 50%. Dividend growth has legs. Corporations are in great shape to increase their dividends going forward and shareholders will increasingly look to blue chip equities for dividends that can grow.

We continue to emphasize dividends and dividend growth in our portfolios. The S&P 500 currently yields a little over 2% and our portfolios are well above that level. In addition to the secular growth case for dividends, there is also a near term case to be made for dividend stocks. When profit growth decelerates, as we expect over the next couple of quarters, dividends become even more important and total return vehicles are particularly attractive. Slower growth environments generally favor higher quality companies, which provide dividend growth. We project that, after lagging earnings growth the past 2 years, dividend increases will significantly outpace earnings growth in 2012 and 2013.

Cypress Asset Management – July 2012

Good News

GLOBAL ECONOMY

Inflation easing globally: oil, natural gas and gasoline prices all lower. *BAML Second Quarter Review July 2012*

China inflation rate cut in half from year ago levels. *WSJ 6.11.12*

Stimulative policy initiatives to boost growth well underway around the world. *FT 7.5.12*

Synchronized global monetary easings by the European Central Bank, Bank of China, and Bank of England bring the ten-month total of stimulative policy initiatives to 203. *ISI 7.8.12*

ECB may be doing more than realized. ECB's balance sheet keeps expanding. ECB balance sheet up about $1 trillion in 2012. *ISI 6.29.12*

Number of global billionaires surges. *Forbes May 2012*

United States

The Economic Situation in Corporate America is Good/
The Economic Situation in Households is Improving

US Corporate America: The Dividend & Cash Flow Machine

US Corporate dividends at record high, growing 14.6% y/y. *ISI 7.9.12*

Despite record high dividends, payout ratio still near record low. *ISI 7.9.12*

Cummins Engines cuts outlook on earnings but raises dividend 25%. *Reuters 7.10.12*

US corporate cash and profits at record levels. *BAML July 2012*

In last weeks of 2Q 2012, 12 significant deals worth $60B have been announced. *WSJ 7.10.12*

US Housing Recovery: Wells Fargo mortgage business revenue up 90% from year earlier and 11% from prior quarter. Note, WFC has more than 30% of US mortgage market. *WFC 2Q2012 Earnings Report 7.3.12*

US bank loans accelerating. Bank loans over past 15 years have increased at a 3.6% rate. Over past three months, have increased to a 4.9% annualized rate. *ISI 7.9.12*

Good Sign for State Budgets: ISI state tax receipts shows 6x increase since 2009. *ISI 7.10.12*

Consumer debt levels are falling. *NYT 4.20.12*

U.S credit cycle is now in expansion phase. Bank loans have been expanding for a year. Total consumer debt in 4Q 2011 increased for the first time this cycle. *ISI 5.1.12*

Consumer finances in much better shape. Interest payments as a percent of disposable personal income at lows since 1990. Credit card delinquency rates at lows since 1990. *ISI 7.2.12*

Bad News

GLOBAL ECONOMIC SLOWDOWN

- The IMF cut its 2012 global growth forecast from 3.6 to 3.5 percent and cut its 2013 forecast from 4.1 to 3.9%...the global recovery continues, but it is a weak recovery… *FT 7.16.12*
- Eurozone Financial Crisis & Recession:
  - Eurozone GDP to decline 1.5% in 2012. *ISI 7.3.12*
  - Eurozone debt problems likely to get worse in near term. *ISI 7.3.12*
- China & Emerging Markets growth slow: China GDP growth slows to 7.6% in the 2Q 2012, its lowest level since early 2009 but still well above hard landing levels. *FT 7.12.12*
- Muslim Brotherhood candidate wins Egyptian Presidency. *FT 6.24.12*

United States

The Fiscal Cliff *(combination of tax increases and spending cuts set to go into effect at start of next year)*

Bernanke: The size of the fiscal cliff is such that there's no chance that the Fed could or would have any ability whatsoever to offset the effect on the economy. *ISI 6.25.12*

Budget cuts in defense would destroy 750,000 private sector jobs and 250,000 government jobs. *Wash Post 6.22.12*

Growing number of economists and business leaders believe fiscal cliff not only threatens growth in 2013 but heightened uncertainty already having an impact. *NYT 7.12.12*

Risks to Second Quarter Earnings

Dollar appreciation: dollar in 2Q 2012 increased about 5% y/y. The headwind from dollar appreciation in 2Q is the biggest in a non-recessionary period in many years. *ISI 6.29.12*

IPO Failure:

Facebook IPO a disaster. *CNBC 5.21.12*

The Leveraged Consumer

Revolving credit grew 11% in May, largest percentage rise since 2007. Overall consumer borrowing rose 8% in May. *WSJ 7.10.12*

The middle class in America is hurting and steadily losing ground. *James Carville in WSJ 7.12.12*

Americans owe more on college loans than credit cards. *CNBC 5.7.12*

Family net worth drops to level of early 1990's. *NYT 6.11.12*

Good News (continued)

Fed open to more Quantitative Easing. Bernanke: "We are prepared to do what's necessary. *FT 7.9.12*

Investors defensively positioned. Net exposure of hedge funds nears three year low. *ISI 6.28.12*

Multi-Year Trends:

Energy & Manufacturing Renaissance in North America

- Increasing U.S. oil production and declining domestic oil consumption puts U.S. on the path to energy independence – essentially zero oil imports projected by decade end *RJ May 2012*
- Record low natural gas prices benefit both U.S. consumers and manufacturers: U.S. natural gas prices are currently under $3, prices in the rest of the world average about $12. Cheap natural gas a competitive advantage for U.S. manufacturers.
- US producing more energy, importing less. Expanded oil drilling helps US wean itself from the Mideast. *WSJ 6.27.12*
- US petroleum liquids production nears 15 year high. US Net imports of petroleum nears 15 year lows. *RJ June 2012*
- Harvard study shows that by 2020, the US will have the second highest oil production capacity in the world, just 10% less than Saudi Arabia. *Harvard Belfer Center 6.27.12*

Housing has turned the corner and could enjoy a sustainable multi-year recovery.

America Feeds the world: U.S. farmers and farmland should continue to be primary beneficiaries of global agricultural bull market, one of the greatest bull markets in modern history.

Favorable demographics in the U.S. for growth versus the rest of the developed world.

The Big Picture

Milton Friedman on the Euro

"At the time of the euro's launch in 1999, Milton Friedman famously observed that the euro would not survive the first major European recession. In the end, Friedman will be proven to have been right." *The Journal of the American Enterprise Institute 2.23.10*

The Supreme Court Upholds Health Care Law

The Supreme Court upheld the Affordable Care Act, with Chief Justice Roberts joining the four liberals on the court in the majority. The majority opinion argued that the mandate was a legitimate use of Congress' taxing authority. Justice Kennedy joined the three conservative justices in the dissent: they would have voided the entire act. *ISI 6.29.12*

The Transitive Theory of Blame

- Spain is not Greece. *Spanish Finance Minister 2.10*
- Portugal is not Greece. *The Economist 4.22.12*
- Greece is not Ireland. *Greek Finance Minister 11.22.10*
- Ireland is not in Greek territory. *Ireland Finance Minister*
- Spain is neither Ireland nor Portugal. *Spanish Finance Minister11.16.10*
- Neither Spain nor Ireland is Portugal. *Sec't Gen of the OECD 11.18.10*
- Spain is not Uganda. *Spanish PM 6.9.10*
- Italy is not Spain. *Fitch 6.12.12*
- When it becomes serious, you have to lie. *Euro Group President, 4.11*
- The worst is now over, the situation is stabilizing, *ECB Draghi 4.12*
- Uganda does not want to be Spain. *Ugandan foreign minister. 6.13.12*

Source: Things That Make You Go HMMMM, *Grant Williams*