CYPRESS
ASSET MANAGEMENT, INC.

MARKET COMMENTARY **October 2012**

Stocks rose in response to a strong dose of global monetary stimulus in the third quarter. The rally began in late July with Mario Draghi's promise that the European Central Bank would do "whatever it takes" to preserve the Euro Zone and then received an additional boost from the Fed's announcement of QE3 – an essentially "open ended" new round of domestic monetary stimulus – in mid-September. Fueled by accommodative monetary policy, the S&P 500 gained 5.76% in the quarter and is up almost 15% year to date. The Dow Jones Industrial Average is up a more modest but still solid 10% on the year.

Market Climbs the Wall of Worry

While the stock market has climbed a wall of worry, a number of cross currents and uncertainties continue to impact the current market outlook. Highlighted are some of the most significant positives and negatives in the "Market Outlook" chart below. Macro concerns may have receded for the time being, but they have not gone away. Europe has certainly not solved its financial crisis and it remains mired in recession, but its two leading actors – Germany and the ECB – have finally signaled a determination to do whatever is required to preserve the Euroland. If Europe is stabilizing, however, the threats from turmoil in the Middle East and a nuclear Iran appear resurgent.

Closer to home we face the risks of the Fiscal Cliff (the combination of tax increases and federal spending cuts scheduled to go into effect the first of next year). The so called Fiscal Cliff has garnered a lot of media attention, and is now largely discounted in the market. While the hyper focus on this proximate deadline is reminiscent of the Y2K frenzy, our looming federal debt and spending crisis will eventually reach a tipping point. How and when we tackle our debt problem and reform entitlements and the tax system depends, of course, on the upcoming election and its outcome. While the outcome of the election is a wild card, it is a certainty that we cannot long avoid the necessity of fiscal reform and confronting our debt problem (see Europe).

Global Slowdown & Profits

These macro risks are likely to be with us for some time and are hard to quantify. On a more fundamental level, global economic growth is slowing and, as a result, concern over corporate earnings is increasing. The Euro Zone is in recession and emerging market growth is slowing from China to India, Brazil and Russia (the nifty BRICs all look pretty ordinary all of a sudden). The IMF recently downgraded its global growth outlook for 2012 and 2013. It now sees 3.3% growth in 2012 and 3.6% in 2013, down from its previous forecast in July of 3.5% and 3.9%. The slowdown in global growth is an economic headwind for corporate profits. Earnings growth is likely to slow to mid single digits in the second half of the year, and even lower for global industrials with significant exposure to Europe and China. But before wondering why investors would want any exposure to businesses outside North America, remember the stock market is forward looking. It has been discounting global growth problems and earnings risk for months now. Global growth should reaccelerate in 2013, but an inflection point in struggling international markets will come long before. We will be looking for a pickup in China and stability in Europe as the keys to an improving global outlook.

GDP Growth Forecasts versus S&P Earnings	2011	2012e	2013e
Global GDP Growth (y/y rate)	3.8%	3.3%	3.6%
U.S.	1.8	2.2	2.2
Euro Area	1.4	-0.7	0
Japan			
Developing Asia	7.8	6.7	7.2
China	9.2	7.8	8
Latin America	4.5	3.2	3.7
Emerging Market & Developing Economies	6.2	5.3	5.6
S&P 500 Operating Earnings (y/y rate)	15	5	6.5

Sources: IMF, ISI Group, BAML

Wave of Global Policy Stimulus In the Pipeline

In response to the global growth problems, central banks and governments around the world are in a stimulative mode that strongly supports asset prices. In addition to the headline monetary moves from the Fed (QE3) and the ECB (Draghi's pledge to use the ECB as an open ended liquidity back stop to support its banks and sovereign debt markets), China, Brazil, Korea, India, Japan and Australia have all moved to cut rates and ease monetary policy. The ISI Group recently counted 275 stimulative policy initiatives (fiscal and monetary) around the world over the past fourteen months. This should provide a tailwind to growth and to equities over the next few quarters. The best way to think about this gusher of stimulus is like fuel injected into a pipeline. It will eventually fuel the economic growth engine but the timing depends on its course through the various complex pathways of our global monetary system. The potential impact for significant inflationary leakage, however, should not be underestimated (e.g. Greenspan and the Tech and Housing Bubbles).

U.S. Secular Strengths

In contrast to the struggles in the global economy, U.S. economic fundamentals are improving in a number of significant areas. We have often written about the energy renaissance in North America, its favorable impact on jobs, economic growth, balance of trade and manufacturing competitiveness. In addition to the ongoing shale energy boom, the U.S. is experiencing an agricultural boom. North America's rich and relatively abundant farmland combined with the growing global demand for food should keep agricultural markets strong for years to come.

But positive trends in the U.S. go beyond our natural advantages in energy and agriculture. A recovery in housing has begun. Housing starts are up, so are existing home sales, and even home prices have finally started to turn up this year. A full recovery may be years away, but that is also good news. A sustainable and long term housing recovery should provide a steady tailwind to economic activity.

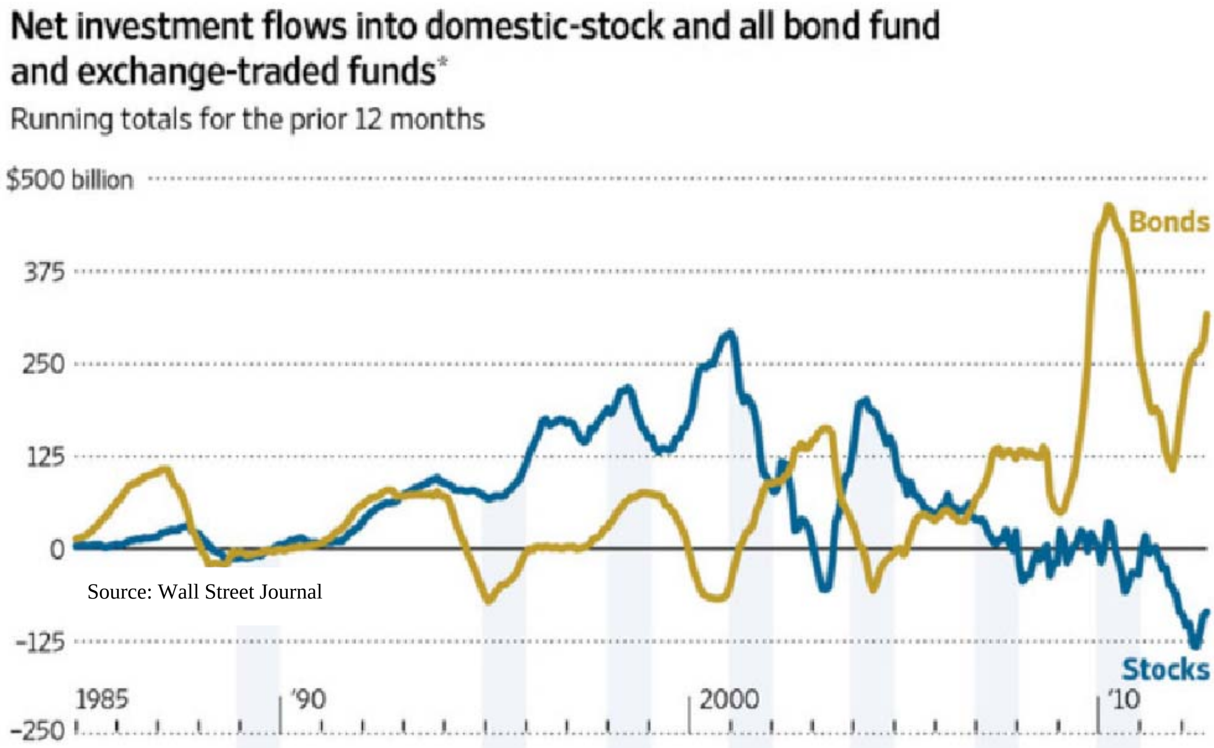
Auto sales are even further into recovery mode, up 65% from the recession low and almost back to a 15 million unit run rate. Auto sales are more cyclical but share similar dynamics to housing; low rates, pent up demand, and an aging fleet support an improving trend over the next few years. So while the U.S. is not enjoying a robust jobs recovery, and growth remains well below the norm of post-recession rebounds, long term structural advantages and positive cyclical trends both point to sustainability.

The U.S. compares very favorably to other developed economies which typically have negative demographic trends, few natural resources, and in most cases have yet to work through their own housing and real estate bubbles or clean up their banking systems. The U.S. financial system has been purged by its worst financial crisis since the great depression. As a nation we swallowed a lot of bitter medicine, some of it well prescribed and some not, and emerged with a cleaner more restrained banking system. Japan is still struggling to do so 20 years later; the European financial crisis is still marked by a lack of transparency and denials, and even China, with all its surplus capital, is not immune from its own construction and real estate bubble and banking problems. The US culture of facing economic and financial difficulties with relatively swift action and transparency have once again left us on stronger footing.

Will Garwood III Joins Cypress

Finally, we are very pleased to welcome Will Garwood, III, as an investment principal at Cypress. Will brings a diverse and valuable background to the firm. He graduated from Princeton University in 2005, worked as an investment banker at J.P Morgan in mergers and acquisitions for two years and then earned an MBA at the University of Texas in 2010. Will gained valuable industry experience post-MBA working three years with privately held oil service company Energy Alloys, a global provider of specialty oilfield metals. He joined Cypress this quarter and will, like the rest of us, serve in several capacities. In addition to investment analysis, Will is leading our marketing and back office systems efforts. We are lucky to have someone as talented as Will, with both investment and operational experience, join the firm. He adds great depth and capability and we look forward to working with him.

Stock and Bond **Flows: The Reallocation Trade**



Money continues to flow out of reasonably valued stocks and into over-valued bonds

MARKET OUTLOOK

Positives

U.S. Economic Fundamentals Improving:

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
- Record low natural gas prices benefit both U.S. consumers and manufacturers: U.S. natural gas prices are currently $3.30, prices in the rest of the world average about $12. Cheap natural gas a competitive advantage for U.S. manufacturers.

Housing has turned the corner and should enjoy a sustainable multi-year recovery. Existing home sales and starts both trending higher; home prices finally turn up; mortgage rates at record lows.

Strong Domestic Auto Market
Auto sales up 65% from 2008 recession low, reach recovery high of 14.9 million units in September.

America Feeds the world: U.S. farmers and agriculture related assets and companies should continue to be primary beneficiaries of global agricultural bull market

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

Attractive Equity Fundamentals:

- Strong corporate fundamentals: Cash, Cash Flow, and Profits at record levels and still growing
- Strong dividend growth: Dividends surged 20% in 3Q 2012 and are now well above prior peak. Even so, the payout ratio remains close to a record low, i.e. lots of room to grow.

Stimulative Monetary & Fiscal Policy Wave:

- Wave of stimulative policy initiatives underway around the world (ISI counts more than 275 stimulative policy initiatives by governments around the world over the past 14 months. Just in the last 2 weeks these include rate cuts in Australia, Korea, Brazil, the Czech Republic and Pakistan; 2 tax cuts by Italy, mortgage modification by Ireland and 2 financial easing moves by China)
- Accommodative Fed & ECB (Bernanke announces "open ended" QE3; Draghi commits ECB to do "whatever it takes" to preserve Euro Zone)

Stocks Remain Out of Favor:
The Great Re-Allocation Trade: 2012 bond fund inflows continue to average over $25 billion per month (extending what is already arguably a bubble), and equity flows remain decidedly negative; at what point do investors re-allocate capital out of fixed income and into stocks. *(See chart titled "Bond and Stock Flows")*

Negatives

Macro Concerns:

European financial and banking crisis

Middle Eastern turmoil & Iran nuclear crisis

U.S. federal debt crisis: Enters center stage post November Election:

- Growing federal debt and entitlements, if not addressed, will ultimately cripple the U.S. economy and fundamentally weaken the U.S. and its global leadership – see Europe.
- The presidential election will likely determine how we will we tackle it – through meaningful entitlement and tax reform and a rationalization of government or through bigger government and a smaller private economy

Tax rates in the U.S. likely to increase no matter who wins election: tax rates on dividends and investment income, and on capital gains are set to go up substantially in 2013. Marginal income tax rate also scheduled to increase by some 13%. Odds favor some compromise over fiscal cliff and tax rates, but not until after election and perhaps not until late January.

Global Growth Slowdown:

- Euro Zone Recession: "Club Med" economies - Greece, Spain, Portugal, Italy- in historic downturns
- China economic slowdown: China struggles to transition to a more consumer demand and domestic driven economy
- BRICs sputter: Emerging market growth slowing from China to India, Russia and Brazil