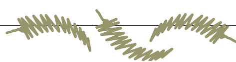
C Y P R E S S

ASSET MANAGEMENT, INC.



MARKET COMMENTARY **July, 2016**

Market Overview

U.S. stocks managed to close out the first half of 2016 in positive territory, with the S&P 500 Index up about 2% in the second quarter and 2.7% for the first half. The market has proved surprisingly resilient to a host of uncertainties ranging from the Chinese economy, Fed rate policy, slowing global growth, negative bond yields, and most recently Brexit and the European Union. These concerns have led central banks and policy makers around the world to continue stimulative monetary and credit policies, providing upward pressure to not only bond prices and equity prices, but asset prices generally from real estate to art work to gold prices.

If we step back, economic growth is very modest and remains challenged worldwide. U.S. markets have advanced at roughly the same pace as the economy over the past 12 months, as have corporate earnings. This is still much better than stocks have performed outside the U.S. over the same period. While the U.S. economy and markets remain relative standouts, it is hard to see what leads to a fundamental acceleration of our economy in the second half. Conditions are solid, supported by a consumer sector that is in decent shape and continued strength in housing, but far from dynamic. The economy might grow a little faster in the second half, but will likely remain in the 2% range.

If the stock market continues to move generally in line with the economy and corporate profits, it would make for a pretty good year. Another 3% rise in the S&P 500 in the second half, matching the first half, produces a 6% gain before dividends. The dividend yield is currently about 2.1%, almost 50% higher than the yield on the 10 year Treasury bond. Even factoring in a reasonable equity risk premium, this represents an attractive total return when compared to most conventional investment alternatives.

Global Economic Outlook & S&P Earnings - July 2016	2013	2014	2015	2016e	2017e
Global Real GDP Growth (y/y rate)	3.3%	3.4%	3.1%	3.0%	3.2%
U.S.	2.2	2.4	2.4	2	2.2
Euro Area	-0.4	0.8	1.5	1.5	1.2
Japan	1.5	0.0	0.6	0.5	0.5
Developing Asia	6.6	6.4	6.2	6	6.2
China	7.7	7.3	6.9	6.5	6.5
Latin America	2.5	1	-0.5	-0.8	1.5
Emerging Market & Developing Economies	4.7	4.6	4	4	4
S&P 500 Aggregate EPS	109	118	117	120	125
Earnings (y/y rate)	12.6%	8.3%	-0.8%	2.6%	4.2%
PE Ratio (June 2016 price @ 2,100)	17.0	17.4	17.5	17.5	16.8

Sources: IMF, ISI Group, BAML

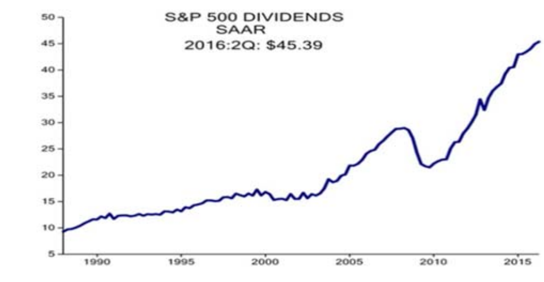
Price Levels	2013	2014	2015	6/30/2016
Nymex Crude ($)	98.4	53.3	37.0	48.3
US Dollar Index	80.0	90.3	98.6	96.1
Gold ($)	1,202	1,184	1,061	1,322
10 year Treasury Bond Yield	3.03%	2.17%	2.27%	1.47%
Market Returns				
S&P 500	1,848	2,059	2,044	2,099
Dow Jones	16,577	17,823	17,425	17,930
Nasdaq	4,177	4,736	5,007	4,843
MSCI EAFE	1,916	1,775	1,716	1,608

As we look into the second half, a number of cross currents are influencing markets and the global outlook:

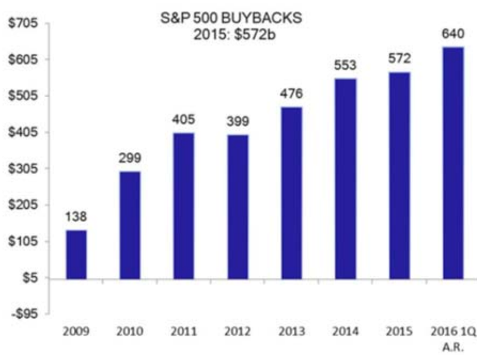
- China's economy appears to be stabilizing. This is alleviating fears of global deflation and reduces the risk of recession. The transition to a more consumer driven economy will continue to prove challenging, however, and contribute to global uncertainty.
- "Slow and Steady Wins the Race" is ISI's view of the U.S. economy. Many economists consider 2%-3% the optimal rate for sustainable GDP growth. While we remain firmly at the lower end of the range, the next U.S. recession is arguably years out.
- "Lower for Longer." A combination of factors including demographics (e.g. aging work force in most of the developed world and also in China due to its one child policy), high debt levels throughout the world, the long running European structural and financial crisis, a general decline in confidence levels and a concurrent rise in populist discontent should continue to dampen global growth rates and keep inflation and interest rates well below historical norms.
- "Negative Rates." Negative bond rates in Europe and Japan (Germany became the most recent nation to issue 10 year government bonds with a negative yield) are a significant market development and will exert downward pressure on U.S. government bond rates. This only serves to reinforce the strong dollar trend and drive global funds into U.S. Treasuries, further inflating bond prices.

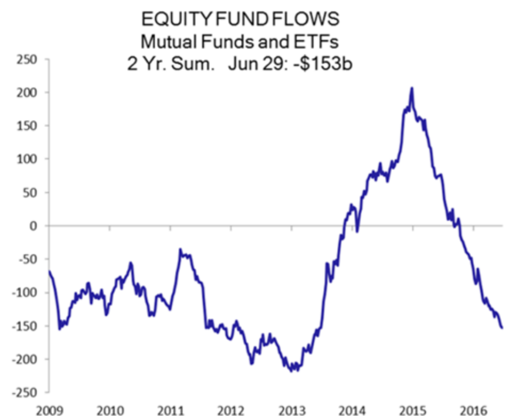
U.S. Equity Market Fundamentals and Valuation: A Mixed Picture

- S&P 500 Dividends are up 5.5% year over year, and currently yield well in excess of the 10 year U.S. Treasury (2.1% yield in S&P 500 is almost 50% above 10 year Treasury yield of 1.5%, record territory for modern markets and supportive of equities).



- Investors are cautious and stocks remain unloved. Despite a record outflow of funds from U.S. equity investors over the past 18 months, and a continued inflow into U.S. Bonds, the equity market has essentially managed to hold its ground. Two factors help explain why:
    1. S&P 500 company share buybacks were $572 billion in 2013 and are running above that level this year. This amount is well above investor outflows and is one of the most significant factors in the market today;
    2. There are fewer sellers left - they have been selling for the last two years.





In essence, strong dividend growth and share buybacks are supporting stocks in the absence of fundamental organic growth. Corporate earnings have been stagnant to declining over the past four quarters. This trend looks set to reach an inflection point in the second half, with a return to a least modest growth in S&P 500 company profits. Much of this reflects an anniversary of the negative impacts from a higher dollar and a collapse in energy sector profits, rather than fundamental improvement.

Market valuation is a mixed picture and difficult to neatly assess. On the one hand, the equity market trades at a somewhat above average multiple, roughly 17.5 times projected forward earnings compared to a historic average of about 16.25. It is also more expensive according to some other measures such as total U.S. equity market capitalization value in relation to nominal GDP. On the other hand, low interest rates and the outlook for continued low rates support higher equity values. In a sense, below average rates and an above average multiple go together.

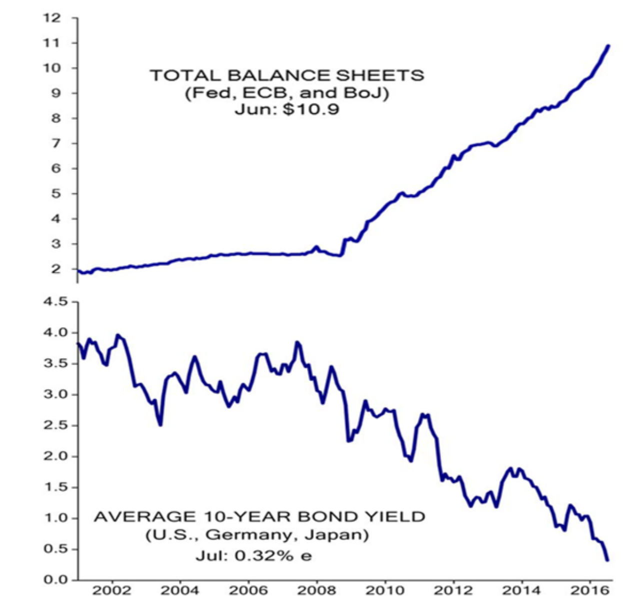
We are in an environment of considerable uncertainty where the unknowns and unknowables loom large. This clouds the valuation picture across the spectrum of financial assets. Where we do remain confident is that the underlying trends of relative U.S. economic strength and dollar strength, low global growth rates, and below norm interest rates should continue to characterize the market environment for the foreseeable future.

Interest Rates, Negative Yields, and Central Banks

During 2016, the financial markets continued to struggle with historically low interest rates. In 2014, several of Europe's central banks cut key interest rates below zero and, now, Japan and Germany have followed. By the end of April 2016, about $8 trillion of government bond worldwide offered yields below zero. By mid-2016, some 500 million people in a quarter of the world economy are living with negative interest rates. According to the WSJ (7-14-16), 33% of all government bonds today have negative yields.

Low and negative rates are an effort by central banks to stimulate their moribund economies, to prevent economies from sliding into deflation. Negative interest rates penalize savers and incentivize borrowers. They punish banks and corporations that hoard cash, hopefully stimulating lending and investing. Theoretically, lower rates reduce borrowing costs for companies and households, driving demand for loans. Of course, this strategy isn't without risk; negative rates may force households to keep cash "under the mattress" or in a safe, with an obvious negative impact on banks. Moreover, lower or negative rates continue to narrow the profitability of banks and could have an unexpected dampening effect on lending.

While lowering interest rates to near zero or negative rates, governments have expanded their own balance sheets by buying fixed income paper from the market and adding it to their own balance sheets (QE or Quantitative Easing). This has been, perhaps, the most significant economic effort in the global markets since the economic slowdown in 2009. Since 2009, The US Fed/European Central Bank/Bank of Japan balance sheets have increased a cumulative $8 trillion from $3 trillion to $11 trillion. It is hard to over-estimate the size and impact of Quantitative Easing. Global QE dwarfs the supply of bonds for sale.



It is noted that not only have lower rates resuscitated a damaged bond market, but they have done so in an environment of exploding credit. Contrary to the normal law of supply and demand, it appears that Central Bank policy has managed to drive rates even lower and expand demand even as the supply of bonds has risen at an ever steepening rate. Seven years of QE and monetary alchemy have not only inflated bond prices, they have buoyed the price of all types of assets: equities, art, real estate, venture capital, sports franchises and Ferraris.