CYPRESS
ASSET MANAGEMENT, INC.

MARKET COMMENTARY **July, 2018**

Market volatility returned in late June amid the escalation of trade tensions, but the S&P 500 managed to hold on to its quarterly gains and end the 1H2018 up 2.6%. Despite these somewhat modest returns, U.S. stocks actually outperformed most other asset classes in the first half of the year including bonds (long-term treasuries -2.9% / investment grade corporates -3.1%) and gold. International equity markets also struggled with MSCI World ex-U.S. and MSCI Emerging Markets down by 3.4% and 6.5% respectively in dollar terms. Even within the U.S. market, there has been a disparity in returns with the Nasdaq Composite Index up more than the S&P 500 and the DJIA still in negative territory for the year.

The fundamental environment remains favorable for equities, as highlighted by our "market balance sheet" shown below. The US economic expansion seems to improve with age and general business conditions are as good as we have seen in many years. Uncertainties over federal reserve policy and the pace of rate hikes, midterm elections, and trade conflicts have increased market volatility and been a headwind for stocks. All of these issues should either resolve or become clearer in the second half of the year, paving the way for potentially much better market performance.

Market Balance Sheet

POSITIVE	NEUTRAL	NEGATIVE
Interest Rates	Dollar	
Economic Growth	Energy Prices	Trade Tensions
	Valuation	
Fiscal Policy		Geopolitical Stability
Inflation		
Profit Growth/Margins		Budget Surplus/Deficit
	Productivity	
Employment	Market Sentiment	
Monetary Policy/Liquidity		

POSITIVE

Economic Growth U.S. growth remains solid and is likely to pick up in the 2H, approaching 3%.

- U.S. consumer net worth has almost doubled during this expansion and the U.S. consumer has significantly delevered. Consumer debt has declined significantly from 130% of disposable income to roughly 100%.

- Small business optimism has surged to a near 45-year high and small business profits have also surged (ISI/NFIB). Tax cuts and deregulation are two factors at work here. All of this is good for employment, wages and capital spending.

Employment

U.S payroll employment has increased by 19 million in the past 8 years or almost 15%. Equally impressive, while payroll jobs increased by another 250,000 in June, the U.S. labor force grew by 600,000 – this helps to explain why the unemployment rate increased from 3.8% to 4%. All of this activity and momentum reflects growing business confidence and is helping to attract workers back to the job market.

Monetary Policy / Liquidity

The Fed remains accommodative in the context of strong economic conditions and liquidity is plentiful.

- Historically, the S&P 500 has appreciated during rate hikes until the tightening cycle is over (2001) or even reversed (1991,2007)
- Slow normalization process: Rates remain low and the pace of rate hikes measured; currently the Fed Funds rate is still running below inflation (PCE). Significantly positive real Fed Fund Rates (i.e. well above the rate of inflation) typically proceed a recession.

Money is easy:

- Global central bank balance sheets (Fed, ECB, BoJ, BoE) have leveled off, but are still almost $16T, up +$12T over the past 8 years. Global short interest rates remain historically low, strikingly low, in the context of global economic activity.
- Strong corporate cash flows and balance sheets are driving an unparalleled series of mergers and acquisitions in both scale and number. It is a world of corporate opportunity fueled by easy money, lower taxes, and a favorable regulatory environment.

Interest Rates

- Interest rates are rising gradually but remain well below historical norms and in the context of strong business conditions perhaps as accommodative as they have been at any time during the current 9-year expansion.
- The bellweather 10-year treasury bond took a run at taking out the 3% level but has fallen back to around 2.85%.

Inflation

The most significant development of the ongoing economic expansion is the combination of solid growth and restrained inflation. Inflation is moving up but not taking off: downward pressures from technology, innovation, disruption. The "Amazon Effect" is being felt across markets from healthcare to retail to logistics and transportation. Average hourly earnings, closely watched by the Fed, are slowly accelerating to the 3% level – modest compared to prior expansion cycles.

Fiscal Policy

Tax reform, repatriation and government spending all set to provide a boost to 2H growth and help offset trade headwinds.

Profit Growth/Margin

Corporate profits are now surging, forecast to increase 21% in 2018 and a still very reputable 7% in 2019. Corporate dividends increased 8.1% y/y in the 2Q2018 – reflecting strong earnings, tax cuts, record levels of corporate cash and business confidence in spite of trade tensions. Earnings estimates continue to be revised upward over the course of the year.

NEUTRAL

Dollar	The dollar began to strengthen in the 2Q but remains below year ago levels. As trade tensions with China have escalated, the Chinese Yuan has depreciated against the dollar – mitigating the impact of Chinese tariffs.
Energy Prices	Oil prices have doubled from their bottom in Spring 2016 but remain at levels well below prior peaks. Shale oil, electric vehicles and rising OPEC supply should all help contain oil prices in the absence of a geopolitical event.
Valuation	The combination of a sideways stock market and a surge in earnings has resulted in more attractive equity valuations. The S&P 500 currently trades at 16.5 times estimated 2018 operating earnings.
Productivity	U.S. productivity has been steadily increasing since 2014 and is on track to increase 1.5% y/y in 2Q2018 and move higher in the second half. Rising productivity is helping to keep unit labor costs down, profit margins high and inflation restrained.
Market Sentiment	Animal spirits are rising but investors remain cautious. Trade war fears, mid-term election uncertainties, geopolitical risks and Fed rate hikes all restrain market exuberance and valuations.

NEGATIVE

Trade Tensions

Trade headlines have grown increasingly disturbing and have raised fears of a trade war with China.

- Worrisome to see rising tension and tariffs imposed on close allies – Canada, Mexico, Western Europe, South Korea and Japan.
- Trade war and tariff headwinds to global growth and markets: The China Shanghai Composite is down 23% from its high, the Korean Stock Exchange down 13%, copper prices have plunged almost 7% and credit spreads are up.
- Thus far most markets have held up remarkably well in the face of disturbing trade headlines. This reflects the strong underlying global economy, improving earnings and valuation levels, and perhaps investors are sensing some "art of the deal" in the trade rhetoric.

Geopolitical Stability

Trade tensions have become the most prominent headline risk, but geopolitical cross currents and the chaotic state of affairs in Washington are likely to remain with us for most of the second half.

Budget Surplus/Deficit

- U.S. budget deficit remains a long-term problem and is forecast to increase by some 20% in fiscal 2018.
- U.S. non-financial debt is also growing rapidly, at 7% versus nominal GDP under 5%, and is continuing to rise to record levels in relation to U.S. nominal GDP. At some point, there will be a price to pay.