MARKET COMMENTARY **October, 2017**

Amid growing confidence in the global economy and corporate earnings, the S&P 500 rose 4% in the third quarter and is now up 12.5% year-to-date. Despite concerns over the length of both the current economic expansion and the bull market, stocks have continued to surprise to the upside and make all-time highs.

Muted Risk Appetite and Market Volatility

While investors may be complacent, they also remain surprisingly cautious and risk averse much as they have been throughout the recovery that began in 2009. Individuals are still buying bond funds even at these low yields because of a preference for investments they see as safer over the uncertainty of equities. Despite a very strong year for equity returns, fund flows are negative. As has been the case since 2008, money has continued to come out of equity ETFs and mutual funds and into U.S. bonds to the tune of billions of dollars annually.

If individual investors are hardly euphoric, hedge fund positioning shows the same cautionary bent. Hedge fund net exposure to equities is about 50% now; in the mid 2000's it was closer to 60%.

The most common measure of market volatility, often referred to as the "fear gauge", is the VIX (CBOE Volatility Index). In spite of global crises, such as North Korea, and domestic political chaos and legislative disappointments, market volatility has been remarkably low. The VIX initially remained elevated during the years following the 2008-9 financial crisis, and again during the European Union existential crisis of 2010-11, but trended down to historically low levels where it has remained over the past year.

Taken together, fund flows and volatility measures suggest that both investor appetite for risk and investor fear are muted. Risk appetite today hardly compares to the late 1990s when investors, greedy for returns, poured into more and more speculative stocks untethered to any valuation measures; or to the mid 2000s when global money chased more and more esoteric debt and derivative instruments tied to an "invincible" housing market. While investors are more positive about both the economy and stocks, sentiment and risk appetite continue to be restrained. The market exhibits complacency, but also a surprising lack of optimism in the outlook for equities.

Valuation Paradox

The issue of equity valuation has persistently hung over the current bull market. Valuation ratios such as price/earnings and market capitalization/revenues indicate that stocks are overvalued and near end-of-cycle levels. On the other hand, valuation measure that adjust for inflation and interest rates, both of which are near record lows, suggest the market is fairly valued. Given our outlook for an extended period of low inflation and lower rates – the new normal in a structurally slower growth macro environment – we come down on the side of reasonable valuation. In fact, were it not for the considerable uncertainties inherent in the current geopolitical environment, of which North Korea is probably the most dire present threat, it could be argued that both multiples and risk taking would be significantly higher. The paradox of the post financial crisis bull market is that a goldilocks environment for equities (neither too hot or too cold) could arise in such dangerous and uncertain times.

Disruption

We have spoken about disruption for the last few years. We are reminded of the investing maxim, "pick any year in history, what everyone believed that year is no long relevant 15 years later." Businesses, business models, social mores, accepted standards, rules of thumb; many of these reliable old measures are changing. Moreover, the rate of change of the rate of change is accelerating. As we have said in the past, there is a generational shift afoot. The power of old, staid brands is weakening and evolving as the post war baby boom generation moves on and the millennials move up. Moreover, global capital flows are shifting as Asia ascends. At the same time, domestically, there appears to be a renewal in strong pro-business trends in regulations and taxation. Finally, there is a monumental shift in logistics, distribution, retail behavior and artificial intelligence roiling its way across the entire business eco system.

We see the results of this change in the stock market. Relatively new companies spring up and gain very large market share in short order. The old guard is having to adapt or fail. There are many older companies beginning to break apart into smaller entities or spin off less core business sectors. Corporate raiders are harassing even the biggest companies. Several of the largest domestic companies are in the beginning of the throes of realigning their business model to adjust to the new realities. There could be many new interesting investment opportunities that come of the current industrial shakeup.

It would be too easy to see disruption in a negative light. We feel that disruption offers opportunity for those open to change. While it exerts downward pressure to wages, a structurally lower inflation environment benefits consumers. As with many other areas in life, in capitalism, when one door closes, often at least another door opens. Cypress will continue to adapt to market and technological disruption. We feel disruption presents both new challenges and new growth opportunities.

Conclusion

The current favorable environment for equities should continue for another year and potentially much longer. The usual factors that warn of a recession or bear market are not evident. U.S. growth remains slow and steady and now the rest of the world has joined in with growth improving in China, Europe and Japan. We believe the economic expansion has considerable room to run. Improving global growth and a weaker dollar have combined to significantly brighten the outlook for corporate earnings. Repatriation would cause a further boost to liquidity and capital investment.

Monetary policy remains stimulative around the world, and Fed rate hikes should remain gradual. Historically, the S&P 500 typically trends higher during Fed tightening cycles, and peaks after the last rate hike. One warning sign would be the development of an inverted yield curve, but there is presently about an 80-basis point spread between 2-year treasuries (1.5%) and the 10-year (2.3%). We will, however, be watchful for change in the conditions that underlie our outlook.