C Y P R E S S

ASSET MANAGEMENT, INC.

MARKET COMMENTARY **January, 2017**

The performance of U.S. large capitalization equities in 2016 was a tale of two markets. For most of the year markets struggled in an environment of slow economic growth, flat earnings, deflationary pressure, and a high degree of geopolitical uncertainty. Prior to the presidential election on November 8th, the S&P 500 was only 2.5% higher for the year, and seemed headed for a flat finish. Much like with the unexpected Brexit vote in June in Great Britain, however, everything changed on the morning of November 9th with the surprising results of a Donald Trump victory along with Republican majorities in the House and Senate. The S&P 500 proceeded to rise 7.5% from this point and ended 2016 up almost 10% on the year.

Investors here reacted favorably and rapidly to the promise of a Trump pro-growth policy agenda: tax reform and simplification, a lower corporate tax rate and repatriation of corporate cash held overseas, and lower individual tax rates for middle income Americans; broad deregulation and governmental regulatory simplification; fiscal stimulus focused on infrastructure spending and job growth. In fact, the shift in sentiment from negative to positive regarding the efficacy of Trump and his economic policies is one of the most remarkable we have ever seen.

Trump is a political maverick, sharply focused on growth and the domestic economy. He is not a social conservative, and seems to have little interest in the social issues that have been an important part of the modern Republican Party orthodoxy. Trump has also challenged the long held bipartisan belief in international free trade, threatening to renegotiate treaties and abrogate open markets in order to protect American industry and jobs.

While Trump may be a political outsider, much of his economic agenda should be compatible to both Democrats and Republicans. The market intuitively understood this, spontaneously reflected in the post-election rally. We believe it is indeed likely that much of the Trump growth agenda is passed in 2017: tax cuts, repatriation, and looking further out a significant infrastructure spending program. Deregulation will begin immediately.

Despite the low growth environment, Trump inherits a pretty healthy economic situation. It is a sturdy platform for the launch of pro-growth initiatives. The U.S. economy is close to full employment as traditionally measured (signified by a 4.7% unemployment rate), even if many Americans have dropped out of the work force. Average hourly earnings have finally begun to rise at a faster pace. Our financial and banking system have emerged from a multi-year healing process after the financial crisis of 2008-9 and appear in good shape. The slow pace of domestic growth itself is a blessing in that it means there is considerable headway to accelerate over the next few years. Finally, in the 4th quarter of 2016 the global economy showed signs of life and seems to be picking up. In sum, Trump inherits a fundamentally sound and arguably improving economy – yet there is a lot of runway for both growth and for tax and regulatory ease and reform.

Market Outlook

We are poised to see a rebirth of capitalism, with all its flaws and excesses. Along with faster growth we expect to see higher interest rates and some increase in inflation. A near decade of ultra-low rates and near zero Fed Funds Rate should reverse as the economy normalizes. We still believe that longer term interest rates and the economic growth rate will remain below historic levels due to secular demographic trends.

Labor-force growth is slowing worldwide, particularly in the developed world and China, and economic growth is primarily determined by growth in the workforce. Productivity, however, the other component of GDP, should see improvement in a more pro-growth policy environment.

Risk capital will be challenged to leave bonds and go to riskier assets like equities. Less encumbered capitalism is messy, and some of this additional risk-taking will succeed and some will end in failure. It will be an uneven and eventful process.

An important question is how much of the good news has the market already discounted. The market expects economic growth and corporate earnings growth to pick up, but it does not know how much. There is considerable room here for not only disappointment but also upside surprises as we saw in much of the 1980s and 1990s.

Passing the Baton

Another important aspect of both the economic and investment narrative is a passing of the baton from the Fed to our elected politicians. The U.S. and global economy have been sustained to a remarkable degree over the past decade by monetary policy. An expansionary Fed played a vital role in nurturing the economy as it recovered from the financial crisis and stimulating modest economic growth in the absence of any significant fiscal policy initiatives in a gridlocked Washington. Monetary policy was the only game in town. The Fed's withdrawal will be gradual, but it will be a complex undertaking and most interesting to see how it all plays out over the next few years.

Conclusion

Going forward, if there is broader and more vibrant economic growth, we believe there should be greater investment opportunity in the Cypress portfolio. As a result of the slower domestic and international economic growth, market performance has been much more narrow over the past several years than during most of our 30-year career. Some have referred to this as the FANG phenomena: Facebook, Amazon, Netflix, Google. All good companies, but symptomatic of a market narrowly focused on a few "super" stocks as perceived winners in a moribund economic environment. As growth broadens and accelerates, we should see significant opportunities in the areas we are traditionally positioned and a return to underlying fundamentals and valuation measures.

Global Economic Outlook & S&P Earnings - January 2017	**2013**	**2014**	**2015**	**2016e**	**2017e**
Global Real GDP Growth (y/y rate)	3.3%	3.4%	3.1%	3.0%	***3.4%***
U.S.	2.2	2.4	2.4	1.7	***2.4***
Euro Area	-0.4	0.8	1.5	1.5	***1.5***
Japan	1.5	0.0	0.6	0.8	***1.0***
Developing Asia	6.6	6.4	6.2	6.0	***6.1***
China	7.7	7.3	6.9	6.7	***6.6***
Latin America	2.5	1.0	-0.5	-0.8	***1.5***
Emerging Market & Developing Economies	4.7	4.6	4.2	4.1	***4.6***
S&P 500 Aggregate EPS	109	118	117	117	***128***
Earnings (y/y rate)	12.6%	8.3%	-0.8%	0.0%	***9.4%***
PE Ratio (January 2017 price @ 2,250)	17.0	17.4	17.5	19.2	***17.5***

Sources: IMF, ISI Group, BAML