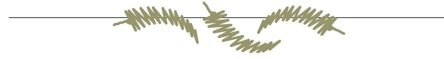
C Y P R E S S

ASSET MANAGEMENT, INC.



MARKET COMMENTARY **October, 2014**

Third Quarter Overview

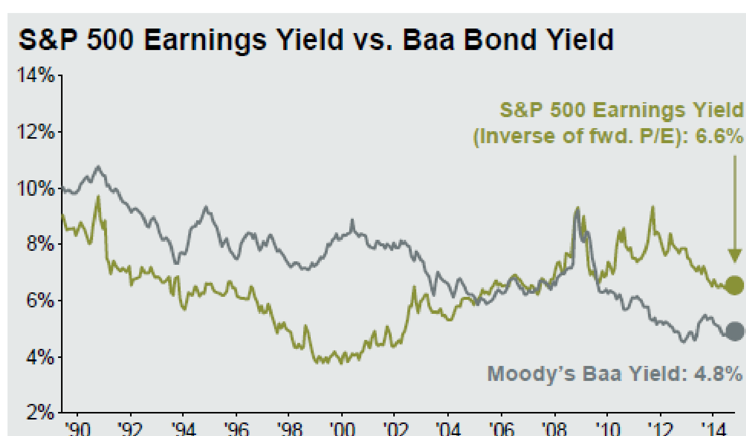
The equity markets moved modestly upwards despite a resurgence of volatility during 3Q 2014 with down months in July and September bookending a steep rise in August. All totaled the S&P 500 and Dow Jones recorded gains of 1.13% and 1.86% respectively, while volatility (as measured by the VIX index) rose 41%. To put the VIX's rise from 11 to 17 in perspective, levels of 40, 43, and 27 were reached during market pull backs in 2010, 2011 and 2012 and the 200 day moving average for the VIX is about 14. The recent 40% increase is more attributable to the extremely low level with which the VIX exited Q2 than its current level being abnormal. Thus far in October we have seen a further increase in volatility (volatility is a shorthand euphemism for "more volatility and less return") due to a variety of interrelated factors, all of which threaten to further slow the global economy:

- *Troubling geopolitical events from the bloody march of ISIS in the Middle East, continued tensions arising from the Russia/Ukraine conflict, protests in Hong Kong, a lack of political will in Europe to tackle its moribund economy.*
- *The end of Federal Reserve Quantitative Easing and general uncertainty of the future course of action by the Fed. But note, the trend remains very accommodative, and Europe is actually restarting its version of QE.*
- *A sharp drop in global commodity prices and in inflation rates from China to Europe to the U.S., raising fears of deflation.*
- *The outbreak of Ebola and concerns over a pandemic and its impact on the U.S. and global economies.*

The Goldilocks Dynamic and Volatility

Currently, there is a "Goldilocks dynamic" related to the American equity markets. The global economy has been in a sustained, but historically very modest recovery, from the 2008 recession. The pace of growth (about 1.5% for OECD economies) has been "not too cold" to halt corporate earnings growth and, perhaps more importantly, "not too hot" to force central bankers to withdraw the support of an accommodative Fed's low interest rate policy and asset inflating government balance sheet expansion. The Goldilocks dynamic has set up a significant shift in the relative value of equities to fixed income which has remained in place since 2009. As noted in the chart below, the S&P earnings yield (the inverse of the p/e ratio: the earnings of the S&P 500 divided by the price of the S&P 500 index) is now 1.8% higher than medium grade Baa bond yields, well above the 25 year historical average of that relationship of -.07%. In other words, bond yields are far below the historical average and, in general, represent a poor long term investment relative to equities - assuming an environment of decent economic growth and low inflation persists. In the event that growth modestly accelerates, confidence increases, and interest rates begin to normalize then bonds would fare even more poorly.

Our outlook continues to be for a sustainable U.S. and global economic expansion of long duration, but at a rate of growth below the historical average. We look for 2.5% growth in the U.S. and 3.5% global growth over the next year strengthening into 2016. A large part of the decrease in volatility over the past few years can be attributed to the fact that there are not a lot of good alternatives to equities for investors, and the economy and financial system have stabilized. We continue to believe that despite the current global concerns equities will remain the best choice for investors.



U.S. Equity: Valuation Measures			Historical Averages			
Valuation Measure	Description	Latest	1-year ago	5-year avg.	10-year avg.	25-year avg.*
P/E	Price to Earnings	15.2x	14.2x	13.4x	13.8x	15.6x
EY Spread	EY Minus Baa Yield	1.8%	1.5%	2.1%	1.2%	-0.7%

Source: JPMorgan

Correction or an End to the Bull Run?

Is the recent return of higher volatility signaling an end to the "Goldilocks" dynamics fueling the equity bull market? For this to be true a significant decrease in corporate earnings (i.e. business cycle recession) or a significant rise in fixed income yields must be imminent. The recent pullback is certainly related to the former "too cold" fear that global macro concerns (conflict in Russia/Ukraine, Hong Kong unrest, ISIS, Ebola) will push European economies into recession and emerging market economies like Brazil and China will continue to slow as export and commodity driven businesses struggle. As this view became consensus, crude oil prices dropped 13.2% during Q3 from $105.21 on July 1st to $91.35 on September 30th. Adding to earnings fears is a rising U.S. dollar which appreciated against the EURO and Yen, negatively impacting the future margins of U.S. global exporters. With these perceived economic and FX headwinds, guidance given by companies as they report Q3 earnings in October will be scrutinized by a market listening for signs of trouble.

The Cypress view is that while earnings headwinds (real or perceived) could further unsettle the market in the near-term, the current pull back will mark yet another successful test of market nerves during the current bull cycle. Continued recoveries in the U.S. housing, auto, and industrial sectors, low levels of corporate debt, and continued stimulative monetary policy, will ballast the global economy enough to prevent a global recession. While a continued run of dollar strength may challenge margins, lower commodity costs and continued increases in technology driven efficiency are offsets that support continued earnings growth. When the dust settles and headline panic has run its course in the markets, equities will represent an even more attractive earnings yield investment, and capital flows will return to equities given the absence of yield elsewhere.

Cypress Holdings are Built to Sustain the Turbulence

The Cypress portfolio is built to ride out these headline panics and actually is positioned to capitalize on downwards spikes in interest rates that accompany these periods. Higher yielding names in consumer staples and the energy infrastructure MLPs tend to be the first to rebound, as selloff fears create yield opportunities the market eventually cannot ignore. We believe the cash flow outlook underlying these yields remains fundamentally healthy and look to stay the course through the turbulence.