C Y P R E S S

ASSET MANAGEMENT, INC.

MARKET COMMENTARY **July 2013**

Q2 2013: Positive returns despite June 'taper tantrum'

U.S. Equities outperformed international markets and outperformed bonds in a quarter marked by concerns over a "tapering" in asset purchases by the Fed. The interest rate on the 10 year Treasury bond rose over 55% in two months from a low of about 1.6% in early May to 2.5% by the end of June. Despite the rise in rates, the S&P 500 posted a 2.9% total return during the quarter compared to -5.6% for long term treasury bonds, -3.4% for investment grade corporates, and -4.3% for the MSCI emerging market equity index.

To a considerable extent the strong relative performance of U.S. equities in 2013 reflects a belief that the U.S. is once again the strongest economic entity in the world. It also has begun to reflect a growing concern that the post crisis period of ultra low interest rates may be drawing to a close. Fixed income investments pose considerable risk as our economy normalizes and rates move higher. We have seen a shift out of non-U.S. equity positions into U.S. equities over the past six months. This trend is likely to continue until we see a pick up in global growth.

We also may be starting to see a rotation out of bonds into stocks. The prospect of higher rates sparked a massive outflow of funds from bonds into cash in June while equities wobbled a bit but remained stable. The U.S. fixed income market is roughly twice the size of the equity market, and over the past five years more than one trillion dollars has flowed into bond funds. So there is a lot of money that could rotate into equities. Longer term, the rotation from bonds to stocks, along with record levels of investible cash, should lend underlying support to the equity market.

Return of the King: Stay with the Relatively Strong U.S. Economy

Our portfolios continue to be conservatively positioned in line with our cautious outlook on global growth. The U.S. recovery is modest and tenuous but contrasts favorably with Europe mired in recession and rising risks in emerging market economies from China to Latin America. The U.S. economy is stable and there are areas of real strength in housing, autos, and domestic energy production. Banks and financial entities are recovering along with housing, real estate, and the consumer. Even the employment picture has improved, with unemployment stabilized around 7.5% and slow but steady growth in private sector jobs. Despite all the fiscal headwinds (federal sequestration, higher taxes, stalemate on entitlement and tax reforms) and the regulatory headwinds (uncertainty over Obamacare, the onerous Dodd-Frank banking rules) the U.S. recovery has the potential to be self-sustaining for the first time since the financial crisis plunged the U.S. into recession some five years ago.

Outside the U.S., however, the global recovery is slowing and emerging markets are struggling to adjust. China is attempting to transition its economy away from a fixed investment and export reliant model by growing domestic consumption and consumer spending. This may well require lower growth (think 5% rather than 10%) but would reduce dependency on exports and lead to a significantly higher standard of living. Latin America, Russia, and other commodity based economies are struggling to adjust to the slower pace of global economic growth. Even the industrial and highly diversified economies of Western Europe and Japan are export dependent

and thus reliant on global growth. Against this global backdrop, the relative self-sufficiency of the U.S. economy (even more so now with the renaissance in domestic oil and gas production) stands out as a significant advantage.

In summary, the period from roughly 2001-2011 was marked by the dynamic growth of China and the emerging markets. The global economy was ascendant. Money and investments followed and flowed into the emerging markets and to their partners and suppliers (e.g. Australia). Now we are a year into a period of slower global growth and as growth slows the risks rise. Money is rotating back into U.S. equities, the reverse of 2001-2011; so it may last for a while.

Global monetary stimulus targets the essential problem of slow growth and too much debt

If we step back, we can see a U.S. and global economy that are struggling to recover from a financial crisis that left the world with unprecedented debt levels. The truth is that Europe, Japan, the US, and perhaps now even China are not growing fast enough to handle the debt that has built up in the system. Expansive spending programs that had been in place for many years (e.g. federal support to housing through institutions like FNMA and FRE, Greek pension largesse, rising entitlement programs like Social Security and Medicare coupled with declining demographic trends, Chinese state directed infrastructure and real estate boom) have led to fundamental questions about the global capital markets ability to support growing debt loads in the wake of the financial crisis and global recession.

In response, the Fed embarked on an unprecedented experiment in stimulative monetary policy. Quantitative easing, or QE, involves large scale purchases of financial assets by the Federal Reserve Banking System to arrest deflation, reduce the burden of debt by lowering interest rates, and stimulate economic growth and employment. It has never before been attempted on such a massive scale. Fed policy has been embraced by the other major central banks of the world, wholeheartedly and with even greater urgency by the Bank of Japan, and more furtively and reluctantly by the ECB.

Will Bernanke and his brethren succeed in this great monetary experiment? Can global economies grow fast enough to service their debt and ultimately reduce the debt level? In the absence of fiscal reform and pro-growth policies, which is the responsibility of elected officials in democratic governments, the prospects for this type of growth are not good. Bernanke and the Fed have bought time for our economy and financial system to heal and helped stimulate a modest recovery. No mean achievement. But ultimately the debt level must be reduced, through growth or reform or inflation or some combination of all of the above.

Tapering in the U.S. should mark a return to a healthier economy and financial system

Fed policy is surrounded by mystery and poorly understood. This has heightened the level of fear and uncertainty about the impact of quantitative easing and the consequences of its withdrawal. It is instructive to think of Federal Reserve policy as creating a massive new entity, the federal Bank of the US. It operated as a "bad bank" in the aftermath of the financial crisis, purchasing troubled and illiquid assets from private banks. Now, through QE, the Fed is operating as a development bank to spur economic activity, specifically targeting housing and the consumer. It does this through the purchase of loans and other financial assets from banks and other lenders. Fed Bank purchases have helped stimulate a recovery in housing and real estate, loan growth, and overall economic activity. It has allowed financial institutions to

recapitalize their balance sheets, bought time for asset prices to recover, and enabled distressed consumer, mortgage, and commercial loans to be refinanced rather than incur a wave of defaults and write-downs. The result is an improving US consumer and employment picture. Extraordinary Fed policy was arguably necessary because the financial system was broken; banks were reluctant, even unwilling, to lend and consumers and businesses were reluctant to invest. Low rates and liquidity injections into the economy were strong but needed medicine.

The Fed has now signaled it is ready to begin tapering its purchase activity and winding down "development bank" operations. The Fed's "development bank" and its assets will begin transitioning back to the private sector. Fed policy will remain accommodative for some time but we are at a turning point. It remains to be seen how the markets and the economy will react: is the US economy finally ready to grow on its own and are interest rates set to begin the process of normalizing?

MARKET OUTLOOK

Positives

U.S. Economic Fundamentals Improving:

Housing has turned the corner and should enjoy a sustainable multi year recovery. Existing home sales and starts both trending higher; home prices finally turn up; mortgage rates rise but still attractive. Housing price improvement may be even more important to overall economy than new house starts.

Strong Domestic Auto Market
Auto sales up 66% from 2008 recession low, reach recovery high of @16 million units in Q1.

Energy & Manufacturing Renaissance in North America

- Increasing U.S. oil production and declining domestic oil consumption puts U.S. on the path to energy independence – essentially zero oil imports projected by decade end.
- Record low natural gas prices benefit both U.S. consumers and manufacturers: U.S. natural gas prices are rose to $4 in Q1 but still far below $12 world average. Cheap natural gas a competitive advantage for U.S. manufacturers.

America Feeds the world: U.S. farmers and farmland should continue to be primary beneficiaries of ongoing global agricultural bull market.

Favorable demographics in the U.S. for growth versus the rest of the developed world

Attractive Equity Fundamentals:

- Strong Corporate Fundamentals: Cash, Cash Flow, and Profits at record levels and still growing
- Strong Dividend Growth: Dividends surge 15% in 2Q2013 and are now well 20% above peak. Even so, the payout ratio remains close to a record low, i.e. still lots of room to grow.

Stimulative Monetary & Fiscal Policy Wave:

- Wave of Stimulative Policy initiatives underway around the world (ISI counts more than 400 stimulative policy initiatives by governments around the world over the past 24 months)
- Accommodative Fed, ECB & BOJ

Commodity prices have cooled providing a boost to consumers and manufacturers, and obviously positive for inflation outlook (e.g. natural gas, copper, corn all down)

Stocks Remain Out of Favor but flows pick up:

- Bond Funds turn sharply negative in June as concerns grow over what happens when "bond bubble" and artificial low rate environment comes to an end….have we reached a tipping point where investors re-allocate capital out of fixed income and into stock?
- Equity inflows remain positive in 2Q2014

Negatives

Global Growth Slowdown extends into 2H2013:

- Euro Zone Recession deepens well into 2nd year: (Southern European Countries: Greece, Spain, Portugal, Italy in historic downturns)
- China economic challenges: China struggles to transition to a more consumer demand and domestic driven economy
- BRICs sputter: Emerging market growth slows from China to India, Russia and Brazil

Tax & Regulatory Headwinds

- Federal Sequestration hurting growth
- Effect of first full year of higher tax rates
- Obamacare uncertainty and financial regulation hampering business investment

U.S. federal debt crisis: How much longer can we postpone meaningful fiscal reform?

- Growing federal debt and entitlements, if not addressed, will ultimately cripple the U.S. economy and fundamentally weaken the U.S. and its global leadership – see Europe.

Macro Concerns:

European financial and banking crisis:

- Stabilized but still capable of flaring, as we saw with Cyprus Bank failures
- Eurozone not growing fast enough to support debt load from periphery

Middle East / Egyptian turmoil & Iran nuclear crisis

Fed Tapering:

- Concerns surrounding Fed tapering their asset purchases, rising interest rates, and impact of winding down of monetary stimulus program