CYPRESS
ASSET MANAGEMENT, INC.

MARKET COMMENTARY

January, 2007

Coming off what can only be characterized as a solid 2006, the prospects look favorable for continued good equity performance in 2007. Fundamentals remain positive: the U.S. economy is healthy and resilient, stock market valuations are attractive, prospects for corporate earnings appear sound and several recent pressure points on the global economy appear to be moderating.

Steady As She Goes

Most investors would not recognize 2006 as the fourth consecutive year of positive domestic stock market returns. As we predicted in the beginning of 2006, the market outperformed most expectations and experienced a bit of catch-up in price appreciation, as stocks had lagged corporate earnings growth in the two prior years. Corporate earnings grew 15% in 2006 (well above consensus expectations going into the year), and the domestic markets generally performed inline with corporate earnings growth. We continue to believe that corporate profits and economic growth will slow going forward, with corporate profits projected to grow in the 5% range in 2007 and GDP growth to moderate from 3.4% to around 2.5%.

The Mid Cycle Slowdown Cometh

Declining profit and economic growth rates should not necessarily be interpreted as bad news; rather, 2007 looks to be the time for a typical mid cycle slowdown –usually a good environment for stocks. Importantly, these prospective growth rates are healthy by long-term standards. Moreover, it was inevitable that the economy should slow from its torrid pace. Several symptoms of that rapid global growth rate are already moderating. Oil and gas prices have declined from their Katrina spike, commodity prices are leveling, the housing market is cooling, and inflationary pressures appear to be subsiding. At this writing, oil is in the low $50 range, 34% off its July peak and at a 19 month low. Copper is off over 30% from the peak. Seasonally adjusted housing starts have declined from over 2 million in Q2 2005 to around 1.5 million currently. Interest rates are essentially flat over the last six months since the Fed halted its long grinding upward march in the Fed Funds rate. We still anticipate a move down in rates from current levels later in 2007. This moderating but sound economic environment combined with continued solid global demand and corporate profitability bode well for stocks.

Valuation, Capital and Predators

Despite a nice 2006 rally, earnings growth merely tracked appreciation in stocks so that domestic equities remain reasonably valued. The S&P 500 currently trades at 15 times 2007 consensus operating earnings, still near a decade low, and in a valuation range flat with last year at this time. We believe there is an opportunity for stock market returns to outperform earnings growth going forward. Corporate coffers are rich with cash, dividend payout remains at very low levels and buyout capital is more abundant than at any time in history. In 2006, a number of large individual deals in the range of $25 billion were announced as private equity firms joined together to take private some very big corporations. There is now talk that these firms may target buyouts in the $50 billion range. The size of private equity transactions is scaling up so quickly that only the largest of corporations appear beyond reach.

An investment banking friend recently said to us, "If it can be LBO'd, it will be LBO'd." In this environment, managements will tread lightly and constantly appraise their opportunities.

There will be a myriad of creative activity in the market place: spin-offs, recaps, special dividends, rationalization, mergers, buybacks, acquisitions and divestitures, and LBO's. Every cycle brings a new wrinkle but one thing remains constant: mergers and acquisitions, share buyback and LBO's will continue to reduce the supply of stock on the margin. At the same time consistent earnings, cash flow and dividend growth make the underlying fundamentals of high quality stocks of available public companies more desirable.

The Dividend Trend is Your Friend

As you know, we are fans of dividends and dividend growth. Cash from the company is good, clean and simple. Unlike the shenanigans related to management options (repricing, back dating, phantom executive meetings and other forms of management compensation manipulation) and the arguments over whether share buyback does or does not reward the shareholder, the dividend is cash in your pocket. The dividend is immutable, it is measurable, and it is yours. On top of that, dividends are currently taxed at the long-term capital gains rate (lets enjoy it while it lasts). Further, dividends of well run companies tend to grow over time. We recently completed a study of the dividend growth trends of our portfolios. Portfolio dividend growth was typically over 20% during 2006. During the last five years, the yearly dividend growth rate in our portfolios has ranged from 12%-25%. These growth rates well exceeded both inflation and stock appreciation.

Where Have All The Bond Yields Gone?

Moreover, compare the dividend growth rate of stocks with returns in bonds and most real assets and the picture gets even more interesting. Treasuries remain mired in the 4-5% range as global capital scours the world for yield. As for real assets, we think it interesting that Sam Zell, one of the premier U.S. real estate investors, recently announced the sale of his holdings in Equity Office Properties. In his annual electronic holiday card, he bemoans the escalation in asset values and the ensuing decline in cash flow returns in real estate – Sam voted with his feet. Finally, as we have said before, the baby boom generation is nearing retirement age and searching for yield. We believe strongly that investors will continue to seek returns in high quality dividend yielding stocks.

Summary

Reasonable stock valuations, a slowing but steady domestic and global economy, good corporate earnings, cash flow and dividend growth, low inflation, a relatively neutral Fed and moderating global commodity pressures could produce another round of double digit market returns in 2007. Should this occur, however, the shroud will be off of the 4 year stealth bull market in U.S. equities. Certainly, global investors will sit up and take notice. Perhaps there is a chance that the U.S. becomes a "hot" market again. Continued good performance in 2007 should reinforce investor confidence and draw new and foreign investors back into our markets after a long hiatus. Your portfolio has had a solid 2005 and 2006, and we believe that long term trends remain very favorable for the liquid, high quality growth and income driven investments that you hold.

Market Balance Sheet

POSITIVE	NEUTRAL	NEGATIVE
Interest Rates		
Economic Growth/Industrial Production	Budget Deficit/Surplus	Geopolitical Stability
Economic Growth/Consumer Spending		
Fiscal Policy	Liquidity (Monetary Growth)	Energy Prices
Valuation	Inflation	
Profit Growth/Margins	Dollar	Regulatory Environment
Productivity	Employment	
Demographics	Free Trade Protectionism	

POSITIVE

Interest Rates — Still relatively low and favorable to equity valuations. Inflation remains contained and outlook is improved by recent pull back in commodity prices. Also of note is the inverted yield curve with long rates below the 5.25% Fed Funds rate. We believe that the next move by the Fed will be to lower rates, probably in the second half of this year.

Economic Growth — Should remain in a healthy 2 - 3% range for the next few quarters.

- Profits and corporate liquidity remain strong, and support both 1) increased business investment and higher employment; and 2) strong dividend growth and share repurchase.
- The economic growth driver has shifted from the consumer to capital spending and industrial production, and toward innovation, small business, and more entrepreneurial activity.

Fiscal Policy — Taxes on dividends and capital gains at lowest levels in over 60 years. Two year extension of the tax cuts on dividends and capital gains through 2010 is a big positive for equity markets.

Valuation — Very reasonable at 15 times estimated 2007 S&P 500 operating earnings. Moreover, stocks are significantly cheaper than bonds, where the bellwether 10 year U.S. Treasury currently yields about 4.70%, and is thus valued at roughly 21.2 times "earnings" (its coupon).

Profit Growth/ Margins — Profit growth should moderate to the 5% range over the next few quarters; profit margins continue at very high levels aided by ongoing gains in productivity, but could come under some pressure from a rise in employment costs.

Productivity — Continues to drive profit growth and keeps the U.S. economy the most competitive in the world; will moderate somewhat as economic expansion matures and we move closer to full employment.

Demographics — Baby boomers in the sweet spot of wealth and investing cycle, hungry for growth and income.

NEUTRAL

Liquidity (Monetary Growth)	Money growth has picked up in recent months, now running at levels at or above nominal GDP.
Inflation	Remains low, but cyclical inflationary pressures are still a concern despite the recent pullback in global commodity prices. We believe any pick up in inflation will prove temporary, as the global economy exerts relentless pressure on prices. In particular, China remains the dragon slayer of inflation, exerting downward pressure on U.S. wages and manufacturing. Low global bond yields and a slightly inverted yield curve in the U.S. also indicate inflation is contained.
Dollar	The dollar has stabilized, but a return of dollar weakness could lead to higher short term interest rates in order to lend support to the dollar. The weaker dollar helps U.S. multinationals, but our trade deficit remains stubbornly high despite the competitive advantages of a lower dollar. It is also worth noting that about 30% of our trade deficit is due to imported oil (net energy imports are currently running at an annual rate of around $300 billion). This is a structural deficit, which has exploded in the last couple of years due to the declining dollar and doubling of global oil prices.
Employment	The employment picture remains quite healthy, with 43 consecutive months of job growth. The 4.5% overall unemployment rate is low by historical standards, and is essentially at a six year low. Still, employment growth has been less robust than in typical recoveries, and the pace of job growth is likely to moderate further over the course of the year.
Free Trade/ Protectionism	Free trade and free market oriented reforms were given a boost by recent election results in Japan, Canada and Mexico.
Budget Deficit	Still a concern at about 2.5% of GDP, but in an improving trend due to surge in federal tax receipts. Would like to see more spending restraint, but need for spending discipline has at least been recognized in Washington. Bigger issue is the persistent growth of medical care costs and the long term liability of retirement in our aging society.

NEGATIVE

Geopolitical Stability	Iraq continues to be plagued by terrorism and sectarian violence. The global terrorist threat will be with us for some time. Although event risk remains significant, investors are becoming more accustomed to dealing with terrorism, scandals and unforeseen events.
Energy Prices	Natural gas prices declined significantly in the fourth quarter, and since the beginning of 2007 oil prices have declined by about 14%. Without a global economic slowdown, however, it is difficult to make a convincing case for a collapse in energy prices. Additionally, in order to be economically viable, most non conventional hydro carbons (e.g. Canadian Tar Sands, coal to liquids, biofuels) need a sustained price of $45 - $50 per barrel of oil.
Regulatory Environment	Federal and state investigations continue to impact individual corporations and entire industries; recent concerns focus on the area of stock options and executive compensation. Changes in Congress also raise the possibility for increased regulation and tax policy changes for certain industries.