C Y P R E S S
ASSET MANAGEMENT, INC.

MARKET COMMENTARY **July, 2008**

Overview

With both the S&P 500 and the Dow Jones Industrial average down 20% from the highs of last October, stocks are officially mired in a bear market. It has been a difficult 12 months, as the housing downturn and financial crisis have inflicted significant pain on both investors and the real economy. While our portfolios have fared considerably better than the market, they have not been unscathed. Perhaps the best news about the official arrival of a bear market is that by the time it reaches the painful bear benchmark of a 20% decline, the market has typically sustained most of its losses. While we do not know when the bear will move on, given the extreme level of gloom and negative sentiment combined with very attractive stock dividend yields and equity valuations based on a PE multiple of less than 15 times earnings, it could be sooner rather than later.

In the mean time, our focus on energy and natural resources, industrials, and global infrastructure together with our holdings in the more predictable and steady consumer non durable sector (e.g. P&G, JNJ, PEP) have helped us to significantly outperform the S&P 500. The Cypress Core Growth Composite and Growth and Income Composite both achieved a positive return in the second quarter and have now outperformed the S&P 500 over the past 1, 3 5, and 10 years.

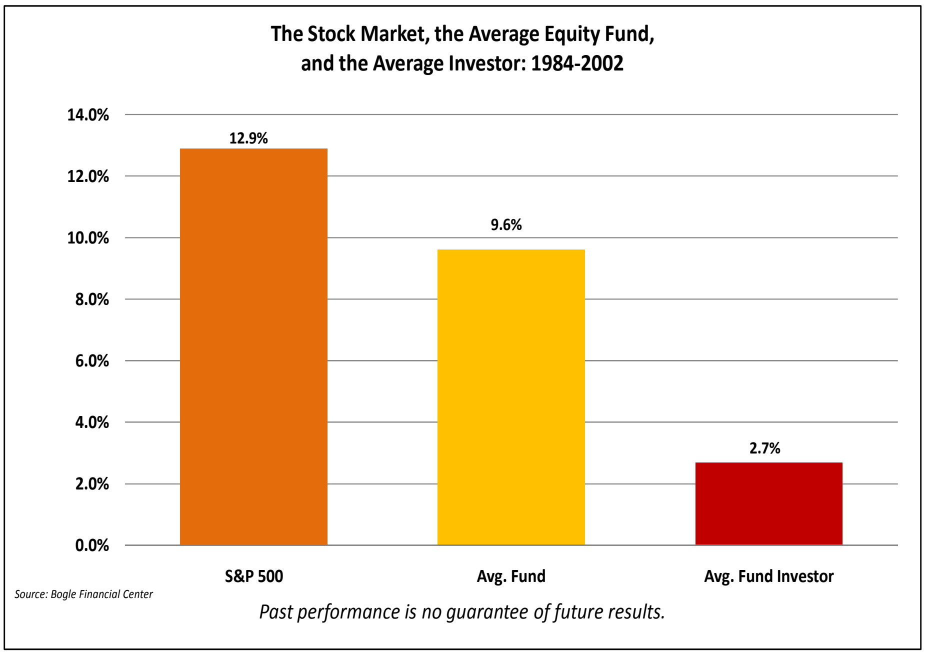
Certainly there is much to worry about and seemingly little to feel good about in today's market. The U.S. economy is in the midst of a historic housing downturn and perhaps the worst financial and credit crisis since the great depression of the 1930's. The consumer is also hurting from record high gasoline prices; essentials like food, electricity, heating and even water are also up and threaten to move higher over time due to supply constraints and higher energy input costs. Some fear that we are trapped back in a 1970's style stagflation of subpar growth and rising inflation.

The Investing Grind

These are extraordinarily difficult and uncertain times, or at least so it appears at first blush in comparison to the relatively smooth road of the last 25 years (mid 1982-mid 2007). But the perspective of hindsight can fool us with its clarity. At the time there was nothing easy about the market crash of October 1987, the stressful periods leading up to both Gulf Wars, the 1990-1992 S&L housing crisis, the Asian currency and Long Term Capital financial crisis of 1997-1998, the dot.com bubble, or September 11, 2001 and its aftermath.

Yes, the American economy and consumer is a sick man today and there is always a chance he will get much worse, but somehow we think a recovery to good health is more likely. We are reminded of the story of King Solomon, who once searched for a cure against depression. He assembled his wise men together. They meditated for a long time and gave him the following advice: Make yourself a ring and have there on engraved the words “This too shall pass”. The King carried out the advice. He had the ring made and wore it constantly. Every time he felt sad and depressed, he looked at the ring, whereon his mood would change and he would feel cheerful. History and experience teach us that investing is a grind, and for most of us nothing is going to come easy in our world. In investing, it is usually the case that the upside is ultimately the reward of enduring the grind.

The following chart from Bogle Financial (John Bogle founded Vanguard Funds) shows what happens to the majority of investors when the grind becomes too much to handle.



From 1984-2002 the S&P 500 had an annualized return of 12.9%, but the average mutual fund investor annualized a paltry 2.7%. The market always conspires to lure the most people in at the top and scare the most people out at the bottom. (By the way, it is greatly abetted in this task by its co-conspirator, today’s 24-7 news media).

Perhaps the wonder is not that the U.S. economy is badly wounded but that it remains relatively strong and resilient. We have simultaneously sustained an oil price shock of similar magnitude to that of the 1970’s which completely disrupted our economy, and a housing downturn perhaps worse than the S&L crisis of 1990-1992 which drove the nation into recession. Yet the U.S. economy continues to expand, albeit modestly, and strong exports could raise Second Quarter GDP to almost 2%. Stay tuned for the Rest of the Story, which highlights some of the positives quietly occurring in our U.S. economy. It is a lot more encouraging and substantial then you might expect.

The Rest Of The Story

It has become popular and even a sign of good intelligence to wring our hands at the sad state of affairs at home and our declining global competitiveness. A former U.S. Senator recently commented that we were literally talking ourselves into a recession. He was pilloried for his insensitivity (he also made reference to becoming a nation of whiners) but he has a point. The fact is that America remains a global leader in many industries, is experiencing a manufacturing and industrial renaissance, and that we are not lacking in good stories across our diverse and balanced economy. But they are certainly not on the front page.

Global Economy

First, we need to recognize the benefits of a strong global economy and the powerful impact of the industrialization of China, India, Eastern Europe, Brazil and other emerging economies. An unprecedented move in emerging economies is unfolding around the world. They are collectively growing at 7% and now account for 30% of global GDP. They have 85% of the world's labor force and are experiencing rapid productivity gains as they pass through different stages of industrialization and its offspring the technology and information revolution.

What they buy (commodities) they inflate. What they sell they tend to deflate (basic finished goods). They also generally have big savings, e.g. petrodollars, central bank reserves, trade surplus accounts, which continue to buoy global liquidity. Ironically, while at the same time global stock markets are in a bear market, we are probably seeing the greatest accumulation of capital and money ever. A significant global slowdown is quite possible in the near term, but emerging markets and the global economy are our future.

A Fed Chairman & Treasury That Are Up To The Challenge

Federal Reserve Chairman, Ben Bernanke and Secretary of the Treasury, Hank Paulson have distinguished themselves in their response to the housing and financial crisis. Some might argue that the government should have done more, sooner; others that it has done far too much (i.e. leave the markets alone to sort it all out). In reality, the response has been forceful but measured and even handed. Bernanke and Paulson have shown strong leadership and proven a very effective team. History should judge them well. We faced a similar grave crisis in the early 1930's and many historians believe the inaction and even restrictive policy response of the Federal Reserve and Administration turned the crisis into a depression. In contrast, Bernanke and Paulson are fully engaged and have not hesitated to use the full force of the U.S. government and all its tools to sustain the blood flow of our financial system.

Financial Deleveraging & Recapitalization

It is painful but banks continue to deleverage, reduce asset risk, and recapitalize. To date U.S. banks have raised more than $160 billion in capital, and European banks another $150 billion (perhaps we should thank our European friends for contributing more than half of the $400 billion in total credit losses sustained to date in what is essentially a U.S. housing and mortgage fiasco).

U.S. Manufacturing Renaissance & Positive Impact of Improving Trade

A U.S. manufacturing revival is combining with the weaker dollar to create an export boom and shrink our trade deficit. U.S. exports are up about 18% year to date while non petroleum imports are only up slightly. Our trade balance ex petroleum goods has improved by almost 20%. This will have a significant positive impact on GDP. (Note that petroleum imports – most of which is for transportation – account for over 40% of our trade deficit and are on pace to amount to a record $450 billion in 2008. This dollar growth in petroleum imports is due primarily to the 400% rise in oil prices over the past 4 years). Economists expect increased exports to add more than 1.5% to GDP in the second quarter. The export boom could potentially keep the U.S. economy out of recession in spite of the rise in oil prices and its unfavorable impact on trade. Below we highlight particular sectors of strength within U.S. trade and industry.

Food & Farming: The U.S. is a leader in corn, soybean and wheat exports and is helping to feed a growing world population. Food exports are up 50% year to date. The U.S. is also the global leader in farm equipment and machinery – think John Deere and Agco Corporation.

One particularly noteworthy American success story in agriculture is Monsanto. It develops genetically enhanced seeds that increase crop yields and farm productivity. This means that farmers can produce more crops on the same amount of land with the same, or fewer, inputs of energy and pesticide. Monsanto's plant or seed biotechnology also increases crop tolerance to heat, drought, excessive moisture while improving protection from insects and disease. Monsanto is the clear global leader, but Dupont is also a player through Pioneer Seeds and its Agriculture and Nutrition unit.

Capital Goods: Made In America Makes A Comeback: The U.S. is now running a trade surplus in capital goods (essentially business equipment and machinery) where exports are up 10% this year after a strong 2007. Major areas of strength include:

- **Aerospace**
  U.S. leadership includes civilian and military aircraft, avionics and systems (all the equipment and controls in the cockpit), aircraft engines and helicopters. Major participants include GE, Boeing, UTX, Honeywell and Textron.

  America also leads in defense and military systems - from aerospace to submarines and aircraft carriers, from guided missiles to missile defense systems, from smart weapons to munitions and tanks. Major firms include Raytheon, General Dynamics, Lockheed Martin, and Boeing among others).

- **Information and Communications Technology**
  The U.S. is the birthplace of the silicon and computer revolution, and has developed almost every modern technological breakthrough from the microprocessor to personal computers to data networking to broadband and 3G wireless. We remain leaders in semiconductors (Intel, Texas Instruments), computer systems and software (IBM, Microsoft, Hewlett-Packard, Dell), telecommunications and networking equipment (Cisco), fiber optics (Corning Glassworks), all manner of wireless and mobile devices (Qualcom, Apple) and internet systems and services (Google, Amazon, EBay).

- **Mining, Excavating and Construction Equipment**
  We are the leader in design, engineering, and manufacturing of equipment used in construction and

infrastructure projects worldwide. Basic infrastructure spending is in the early stages of a long boom led by emerging markets but joined increasingly by industrialized nations who face a need to rebuild and repair aging infrastructure. U.S. equipment makers and U.S. engineering and construction firms (e.g. Bechtel, Fluor, Foster Wheeler) are busy building power plants, refineries, pipelines, water and wastewater systems, storage tanks and facilities, roads, bridges and airports, and mines to extract iron ore, copper, coal and other basic metals.

Caterpillar is synonymous with construction equipment and moving earth worldwide; but lesser known companies like Joy Global and Bucyrus are also leaders in mining and excavation equipment which is experiencing a historic global boom.

U.S. companies also provide the flow control and measurement systems that are inside the refineries, power plants, pipeline systems, other industrial process plants and even commercial buildings. Major participants include Honeywell, Emerson, UTX and GE.

- **Power Generation & Distribution**

We are facing a shortage of electrical power in emerging economies like China, Brazil, and South Africa, and even within our domestic market where we have under invested for some years. GE is a global leader in all forms of power generation systems (coal, natural gas, nuclear) and many of the previously mentioned infrastructure companies are sub system and component suppliers.

- **Medical Equipment**

U.S. companies are leaders and pioneers in all types of medical products and equipment including diagnostic imaging, oncology and radiation, coronary devices, and orthopedic reconstructive implants. Major participants are Johnson & Johnson, Abbott, GE, Medtronic among a very long list.

Drilling & Oilfield Services

We may be the world's largest importer of oil, but we are also far and away its leading provider of drilling and production services. What technology could be more valuable in our hydrocarbon resource constrained world. U.S. leadership includes critical technologies such as enhanced recovery techniques (e.g. horizontal drilling, reservoir fracturing), deepwater drilling and production equipment, compression technology, environmental safeguards, and techniques and equipment for harsh and hazardous environment. Leading companies include Schlumberger, Halliburton, Weatherford, Cameron, Transocean Drilling, National Oil Well Varco, Diamond Offshore and Nabors Industries.

North American Natural Gas

There is a boom in North American natural gas to rival the downturn in American housing. After being flat for many years, total U.S. natural gas production is up about **9% year to date**. A number of promising new fields have been found from the Dakotas to the Appalachian region down to the Gulf Coast. New drilling techniques and higher prices have opened up "shale" plays in regions that have been inactive for years. Some of these shale plays offer the added potential of sweet, light crude oil.

With environmental opposition to coal generated power and "not in my backyard" opposition to nuclear power and waste storage, clean burning natural gas is the only near term solution to the rapidly growing demand for more electrical power. Power generation is already close to shortage in major population regions of the U.S. As a result, the outlook for natural gas for electricity is very strong over the next decade. Not to mention the potential further development of natural gas to liquids technologies. Gas to liquid fuel could become a basic gasoline feed stock, lessening our oil dependency. Leading North American independent oil and gas producers include Devon, Apache, XTO, EOG and Anadarko in an industry that is growing in numbers by the month.

Finally my friends, as Paul Harvey has told his radio listeners for more than 50 years, "and that's the rest of the story…good day".

Market Balance Sheet

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

POSITIVE

Interest Rates — Interest rates are low and very favorable to equity valuations. The Fed has moved aggressively to lower the fed funds rate from 5.25% down to 2.00% and is now likely to remain on hold for some time. Inflation expectations remain a concern but should moderate with a slowing economy.

Economic Growth — GDP should remain positive, barely, over for the next few quarters. We see the odds of a domestic recession as having increased in recent months, but the combination of a weak dollar boosting U.S. exports and a strong global economy could be enough to keep us out of recession.

- Profits and corporate liquidity are a mixed picture but generally remain strong outside the housing related and financial sectors.
- The housing downturn and the slowdown in domestic economic growth has been accompanied by a historic increase in defaults and decline in home values. There continue to be losses associated with defaults, foreclosures and asset write-downs, and the housing weakness has spread into the consumer segment of the U.S. economy. We believe certain sectors, however, such as natural resources, materials, and infrastructure related industrials are particularly well positioned for continued growth.

- As we have previously noted, the longer term 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 would be at risk in a Democratic administration. The 2008 tax rebate and fiscal stimulus package is providing some support to the economy and to the consumer.
Valuation	Very reasonable at about 14.5 times estimated 2008 S&P 500 operating earnings. Moreover, stocks are significantly cheaper than bonds, where the bellwether 10 year U.S. Treasury currently yields just under 4%, and is thus valued at roughly 25 times "earnings" (its coupon).
Profit Growth/ Margins	Corporate profits are forecast to be down modestly over the next two quarters due to losses in the financial sector, but ex financials, corporate profits are actually forecast to be up almost 10% this year. Profit margins continue at very high levels aided by ongoing gains in productivity, but are under pressure from both a rise in raw material costs and a weaker consumer.
Productivity	Continues to drive profit growth and keeps the U.S. economy the most competitive in the world; has begun to reaccelerate due to lower employment growth and a weaker dollar boosting U.S. manufacturing competitiveness.
Demographics	Baby boomers in the sweet spot of wealth and investing cycle, hungry for growth and income.
Liquidity (Monetary Growth)	Broad money growth and global liquidity remain very strong. Global broad money (e.g. MZM) is growing at better than 10% on a year over year basis according to ISI Group.

NEUTRAL

Inflation	Cyclical inflationary pressures are significant across global commodities and basic resources from agricultural products to energy and metals. We still believe the recent pick up in inflation will prove temporary, as the slowing global economy reduces demand and creates slack in employment and manufacturing. Persistently low global bond yields, including longer term government rates, also indicate a belief inflation is contained. The appreciation in energy prices and natural resource assets (farm land, oil, metals and minerals etc.) has been offset by deflationary asset depreciation in residential real estate and equities.
Dollar	The weaker dollar helps U.S. multinationals and exports, but our trade deficit, though improving, remains stubbornly high despite the competitive advantages of a lower dollar. It is also worth noting that over 40% of our trade deficit is due to imported oil (net energy imports are currently running at an annual rate of about $400 billion). This represents a structural deficit, which has exploded in the last couple of years due to the declining dollar and doubling of global oil prices. It should also be noted that the weakness of the U.S. dollar is ultimately an inflationary force, and significant further declines could be damaging to the U.S. economy and restrict our monetary options.
Employment	After a record 55 consecutive months of job growth the employment market has weakened in 2008. Thus far monthly job losses have been modest but persistent. The 5.5% overall unemployment rate is still relatively low by historical standards, but is likely to increase over the next few months due to continued housing related fall out.

Free Trade/ Protectionism	Free trade and free market oriented reforms were given a boost by recent election results in South Korea, France, Canada and Mexico. However, there is some concern a new administration in Washington could be more protectionist.
Budget Deficit	Currently running at less than 1.5% of GDP, but likely to increase in the second half of the year due to the tax rebates, fiscal stimulus\housing relief package, and lower federal tax receipts. We would like to see more spending restraint. 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 stabilize and improve, with political progress now following the reduction in sectarian violence. The global terrorist threat will be with us for some time as will the issue of a nuclear Iran. Although event risk remains significant, investors are becoming more accustomed to dealing with terrorism, scandals and unforeseen events.
Energy Prices	Oil prices remain elevated and ended the quarter at almost $140/bbl, roughly $45 above where it started the year. Domestic natural gas prices rose sharply to average around $11.30/mcf in the quarter and closed at $12.88/mcf, up 90% from year ago levels. While there remains a geopolitical risk premium in the price of oil, without a significant global economic slowdown, it is difficult to make a convincing case for a sustained drop in energy prices. Additionally, in order to be economically viable, most non conventional hydro carbons (e.g. Canadian Tar sands, ultra deep water, coal to liquids, biofuels) need a sustained price of about $70 per barrel of oil or higher.
Regulatory Environment	Recent changes in Congress and the Presidential election raise the possibility for increased regulation, tariffs and tax policy changes for certain industries, as well as higher marginal tax rates for individuals.