CYPRESS

ASSET MANAGEMENT, INC.

**MARKET COMMENTARY** **OCTOBER, 2011**

The third quarter began with a rancorous debate in the U.S. over raising the federal debt ceiling, culminating in the now infamous Friday night S&P downgrade of the U.S. credit rating for the first time in history. With confidence badly shaken, the steep market selloff continued due to fears over the European financial and sovereign debt crisis. In one of the worst third quarters on record, the S&P 500 declined 14% and stocks fell roughly 20% worldwide:

| | QTD | YTD |
|---|---|---|
| London FTSE | -13.74% | -13.08% |
| Spain IBEX | -17.50% | -13.31% |
| Japan Nikkei | -11.83% | -14.94% |
| **Shanghai Composite** | **-14.50%** | **-16.00%** |
| Australia | -12.70% | -15.50% |
| Korea Kospi | -16.75% | -13.72% |
| Toronto SE | -19.70% | -18.00% |
| **German Dax** | **-25.41%** | **-20.42%** |
| Paris Cuc 40 | -25.40% | -21.63% |
| **Euro Stoxx 50** | **-23.48%** | **-21.95%** |
| Hong Kong Hang Seng | -21.46% | -23.63% |
| FTSE MIB (Italy) | -26.51% | -26.46% |
| Brazilian Bovespa | -30.54% | -33.40% |
| Greece | -37.58% | -43.53% |
| **DJ World (ex U.S)** | **-20.20%** | **-18.60%** |
| MSCI EAFE (in $) | -19.60% | -17.18% |
| **S&P** | **-14.33%** | **-10.04%** |
| **NYSE Composite** | **-18.40%** | **-14.70%** |
| NASDAQ Composite | -12.94% | -8.95% |
| Russell 2000 | -22.15% | -17.80% |
| Russell 1000 | -15.12% | -10.54% |

*Sources: WSJ, BAML*

Broader measures of U.S. equities tell an even grimmer story, with the Russell 3000 off 15.7% and the NYSE composite down 18.4%. Europe was the eye of the storm, both the German DAX and French CAC fell 25% in the third quarter. Emerging markets were also hard hit as reflected in a 21% drop in Hong Kong's Hang Seng Index, a 30% decline in the Brazilian Bovespa, and a 17% decline in the South Korean Kospi.

The truth is that no one really knows if the European Union can rise to the challenge and resolve its fiscal and geopolitical crisis.  But with the memory of the 2008-2009 financial crisis still painfully fresh, stocks were under relentless selling pressure throughout the quarter.  Energy, materials and industrials were particularly hard hit in the quarter due to rising concerns over a double dip in the U.S. economy and global recession.

## Sentiment, Uncertainty, and the Reallocation Trade

The mounting fears and investor uncertainty are reflected in the massive flow of funds out of equities.  The Wall Street Journal reported that investors world-wide pulled almost $100 billion out of stock funds in the developed markets in the three months through August 2011, and withdrawals showed no sign of slowing in the first three weeks of September.  Investors have now pulled more money from U.S. equity funds since the end of April 2011 than in the five months after the collapse of Lehman Brothers.

A lost decade in equities combined with the near-term disenchantment with stocks has led retail investors to seek the "safety" of fixed-income despite the absence of yield, and left hedge funds at their lowest net long positions since early 2009.  Since the beginning of 2007 individual investors have had a record swing of $1.2 trillion-plus, $400 billion-plus in equity fund outflows against $800 billion-plus of inflow into bonds.

Equities are as out of favor today as perhaps at any time in history.  Stocks essentially reflect our confidence in the future, so there is some logic to this loss of faith.  Optimism about growth in the future and rising living standards means stocks will be worth more over time, but the opposite also holds true and many Americans no longer feel they will be better off in the future.

Today there is a crisis of confidence and the underlying cause is uncertainty.  Uncertainty lies at the heart of the loss of faith in the market and the stagnation in the U.S. and European economies.  Uncertainty is why new job opportunities are not materializing, businesses are not spending and hiring, and investors are selling stocks.  Businesses are uncertain about future policy, and they will not invest for the future until they have a better idea of what it holds. On many days, it is hard to imagine a happy ending to the story.

From a contrarian standpoint, however, we could be approaching an inflection point or at least a bottom in investor sentiment and the exodus out of stocks.  At some point institutional investors (e.g. pension plans, foundations and endowments), heavily skewed toward fixed income and cash, will reallocate capital back into equities.  Given the current imbalance and the historically low level of bond yields (the yield on the S&P 500 exceeds the 10-year U.S. bond yield),  a massive reallocation is possible if not inevitable.

## Teach A Man To Fish

As we wrote in our last quarterly commentary, both the European and the U.S. fiscal crisis reflect deeper structural issues and challenges that go to the heart of our economic future. They are issues and risks that will be with us and with investors for some time. A more robust U.S. recovery and employment picture must likely await structural change: tax and regulatory reform and simplification (our complex and burdensome tax and regulatory policies disfavor domestic investment and encourage foreign investment); serious entitlement reform – the key to any solution to both our current and long term fiscal deficit and debt burden; a rationalization of government itself.

Sadly the "recovery" that we have enjoyed so far has been in spite of rather than encouraged by our government policies and trillions of dollars in temporary stimulus (as opposed to infrastructure investments that can provide a long term benefit and return on investment). The current administration has taken what was eight years of pretty bad economic policy and managed to make it worse. If it wasn't for the strength of emerging economies and their growing influence over the global economy, we would certainly be in considerably worse shape than we are now.

Paul McWilliams, one of our favorite commentators, puts it this way:

> *The old Chinese proverb applies: "If you give a man a fish you can feed him for a day, but if you teach him to fish you'll feed him for a lifetime." Giving stimulus is like giving fish – it is necessary when our man is hungry. However, unless you want to plan to hand out fish every day, you better also include some fishing lessons. In this case, those fishing lessons would be to update regulatory and tax policy to recognize the many changes that have been driven in the world by emerging economies…and to significantly reduce federal spending. Our current policies disfavor domestic investment and literally subsidize foreign investment.*

In a similar vein, Federal Reserve Chairman Ben Bernanke recently said that the United States and other rich nations could learn a few lessons from developing countries: adopt disciplined budget policies, embrace free trade, make public investments and support education.

George Schultz says tax reform is the first place to start. Now 90 years old, Shultz is an American icon, having taught Economics at MIT and Chicago, and served as Secretary of Labor, Secretary of Treasury, and finally Secretary of State under Ronald Reagan. At a recent dinner in his honor at the non-partisan Economic Club of New York, he suggested we "clean out the tax preferences and lower the marginal tax rates for both individuals and businesses to at least 20%":

> *"You'll get a gusher…A simplification of the tax code would allow Congress to lower rates on a revenue neutral basis, while economic expansion would boost tax receipts. If you get this kind of stimulative tax policy, there will be a response and revenue will come in…It's the wealthy people and the GE's of the world who are the beneficiaries of a complex tax system, that know how to manipulate there preferences and get their tax rates down."*

## Market Inflection Points

There are probably only two inflection points over the next year that could provide a sustainable positive move to the upside in the markets. (If Europe is able to resolve its debt crisis, however, this would remove much of the current uncertainty and at least take the doomsday scenario off the table. This could give rise to a pretty powerful “relief” rally into year end and early 2012).

The first potential positive inflection point is unfortunately a low probability event, meaningful fiscal reform and spending cuts from the new congressional budget super-committee. This would ideally include significant reductions in federal spending and the budget deficit, a start toward real entitlement reform, and the type of “revenue neutral” tax reform which eliminates preferences and lowers rates and stimulates growth. Much of this was outlined earlier in the final report of the President’s bipartisan deficit commission chaired by Alan Simpson and Erskine Bowles (January 2011 Report). Admittedly this is a long shot, and expectations are pretty low for anything meaningful to come out of the super-committee in today’s dysfunctional, election cycle political environment.

Moving forward, the next inflection point will be when the markets begin to handicap the November 2012 national election. If the market handicaps a result which breaks the political gridlock in the direction of rationalized and downsized government, fiscal reform, and a return to growth, we should see a powerful and sustainable rally.

## Conclusion: Why We Own Stocks In The First Place

In uncertain times like these, when macro concerns and policy questions dominate the markets, it can be helpful to reflect on what it is we actually own. Fundamentally, our companies are in good shape and very profitable. They are maintaining and growing dividends, returning money to shareholders, and investing globally for future growth. We own businesses that produce and sell things that people want and need. They are not going away. They will be there when the storm passes, so let’s not lose sight of why we own stocks in the first place.

## Cypress Asset Management – October 2011

# Good News

## China

Hang Seng Index becomes the first Asian major equity benchmark to exit bear market territory. The gauge of Chinese companies in Hong Kong rallies 39% from October 4 to October 13. September marked the worst month's performance in 3 years. *Bloomberg 11.13.11*

China Government economist sees third quarter GDP at 9.2%, CPI 5.5%. *FT 10.11-11*

China vehicle production, industrial production and retail sales all up 14-16% in August. *ISI 9.12.11*

China vehicle sales rose 1.61 million, up about 6% year over year. 2011 Estimates raised. *ISI 10.13.11*

Chinese September 2011 imports were $155B, up 20.9% year over year. *ISI 10.13.11*

China unveils small and medium enterprise lending plan in an area where credit has been tight in response to Wenzhou city failures. *FT 10.13.11*

McDonalds plans to open a restaurant a day for the next 3 to four years, up from a restaurant every other day. *Bloomberg 7.29.11*

Yum Brands (KFC, Taco Bell, Pizza Hut) added 138 stores in China during its 3Q and strong China market sales drive profit growth despite weak U.S. *WSJ 10.6.11*

Renminbi currency bonds top Euro bonds for the first time. Third quarter, 2011 marked the first time that Chinese currency bonds ($31B) outpaced Euro currency bond issuances ($26.4B). *FT 9.29.11*

## Europe

**Daily Debt Debacle Déjà Vu**

Europe passes a TARP, the ESFS, a 440B Euro financial support vehicle. EU also moves forward on parallel plan to recapitalize its banks. *FT 10.9.11*

German Parliament votes "Yes" on Euro Rescue Fund. *ToryCapital.Com 9.29.10*

Last Euro country, Slovakia, approves Euro bailout fund. *10.12.11*

ECB reintroduces longer-term bank loans and resumes purchases of covered bonds, measures "necessary to help restore a better transmission of interest rates to the real economy." *Bloomberg 10.13.11*

G-20 said to be weighing additional IMF lending power to aid Europe. New funding expected from China, Brazil, and Japan. *Bloomberg 10.14.11*

# Bad News

## China

China regulators tell banks loan provisions inadequate. *Bloomberg 7.29.11*

Bank of China halts FX trades with European Banks. *Reuters 9.20.11*

Chinese copper inventories still appear too high, but now off 25% year over year 2010 to 2011. *ISI 10.13.11*

Chinese trade surplus has declined from $297 b in 2008 to $144 b est. in 2011. Still too high for US politicians looking for a trade fight. *ISI 10.13.11*

China's export growth slows and the customs bureau warned of "severe" challenges as the global economic outlook dims. *Bloomberg 10.13.11*

Receding Chinese economic tide today stands in contrast to strong Chinese demand when the recession started in 2008. *ISI 10.7.11*

Collapse of Chinese manufacturers and loan failures in Wenzhou city attracts media attention and draws into question Chinese bank asset quality. *Bloomberg 10.12.11*

Credit Suisse issues report stating that Chinese bank loan losses may climb to level equivalent to 60 percent of their equity capital as real estate and local governments fail to repay debts. *Bloomberg 10.12.11*

## Europe

**Daily Debt Debacle Déjà Vu**

Moodys Investor Service again downgrades Greece's credit standing, setting the stage for a likely declaration that the country is in default as a newly approved rescue plan moves forward. *Washington Post 7.25.10*

Spain, Italy, and Portugal all see credit rating downgrades.

Greek government now expects economy to shrink more than 5% in 2011. Greek 10 year bonds yield approximately 25%. *Bloomberg 9.13.11*

Credit default swaps on largest French banks surge to all time high on bets they will have ratings cuts by Moodys. *Bloomberg 9.13.11*

US money funds cut loans to French banks by 44% in September. *Bloomberg 10.14.11*

Up to $266B needed for Europe Bank bailout, according to IMF European Department Director. *CNBC 10.5.11*

## Good News (continued)

**United States**

**Stock prices remain cheap, corporate profits grow**
Investors are playing less for equities than they have during every recession since Ronald Reagan was president; S&P Index trading at 12.9 times trailing earnings, 3.5 multiple points less than the average multiple during the last 10 contractions since 1949 and a level last reached in 1982. *Bloomberg 8.30.11*

**The US Corporate Engine**
A global economic slowdown will hurt corporate profits but since the S&P peak 11 years ago, profits have surged 131% to record level and bond yields have declined 428 BPS. *ISI 10.3.11*

S&P 500 companies increasing dividends at the fastest pace in seven years. S&P 500 dividend yields move above 10-year US Treasury Yields. *Market Watch 9.2.11*

**Resilient Consumer**
Real consumer spending growing at slow pace but already above its 2007 peak. *ISI 8.31.11*

**Payroll employment and household employment still "OK".**
Payroll employment gains have averaged 96,000 over the past three months and household employment has made a new post-recession high. *ISI 10.7.11*

**Rates remain low**
The Federal Reserve announced on Tuesday that it plans to hold the benchmark interest rate at "exceptionally low levels" through at least mid-2013, breaking from the central bank's usual less precise timelines. Ten year treasury remains in historically low 2% range as of 10.14.11. *Politico 8.9.11*

**Trillion Dollar Tax Holiday for Repatriation of Overseas**
US multinationals have $1.5 trillion in profits overseas. In 2004, the government declared a tax holiday, bringing home $312 billion. Multinationals now pressing for another tax holiday or incentive. *Bloomberg 8.3.11*

**Economy seems to be doing better than the stock market**
Economic indicators that show the economy is actually doing ok include: vehicles sales, chain-store sales, manufacturing PMI, non-manufacturing PMI, construction spending, employment, state tax receipts, unemployment claims, bank loans. *ISI 10.9.11*

Apple IPhone sells out pre-orders at ATT, Verizon, and Sprint
*Bloomberg 10.14.11*

US Gamers crack puzzle in AIDS research that stumped scientists for years. *Fox 9.19.11*

## Bad News (continued)

**United States**

S&P downgrades US credit rating for the first time. Many Euro countries maintain AAA rating. *Washington Post 8.5.11*

"S&P was wrong to downgrade US," Walter Schroeder, founder of Canadian rival rating agency, DBRS.

International picture is of greater concern now than in 2008 as epicenter of the problem appears to be Europe, and China growth, while still healthy, is slowing. *ISI 10.7.11*

Dodd-Frank financial regulation bill scheduled to go into effect in 2012. Rules are still being written, remains unclear how it will ultimately impact an industry still reeling from asset and revenue problems. *NYT 10.14.11*

Global slowdown to impact US. ISI real GDP growth projections for the next three quarters: US 1%, Euro -1%, Japan 0%, Emerging Markets 4.5%. *ISI 10.2.11*

**Rout in stocks**
Investors have pulled out more money from US equities since the end of April than in the five months after the collapse of Lehman Brothers, adding to the $2.1 trillion rout in American stocks. Worldwide, investors pulled out $92 billion in the developed markets in the three months ended August, 2011. *Bloomberg 9.19.11 and WSJ 9.27.11*

**Job cuts continue**
Bank of America cuts 30,000 jobs. Goldman Sachs may cut up to 3,000 jobs. Merck to slash workforce by 12 -13%.
*Market Watch 9.12.1,Bloomberg 7.29.11 and International Business Time 9.27.11*

Bernanke: US labor market is in a "national crisis" and the housing market needs aid. *MarketWatch 9.28.11*

## Energy Renaissance

**The Greatest Story Never Told**
China needs to import about 5mil bbl/ day just to satisfy the domestic supply versus total consumption imbalance. ISI estimates that 2011 car sales in China will be 18.7 mil units. 2015 estimates for Chinese car sales: 30 mil units. *ISI 10.13.11*

**Rig Count Rising**
US Rig Count has moved back above 2000 for the first time since September 2008. Rig count is up 24% year over year and projected to reach highest levels since early mid 1980's in next 12 months. *WTRG Economics 10.10.11*

**Utica Shale Newest Big Find:**
The newest huge find of nat-gas and gas liquids… including ethylene and crude… is the Utica Shale formation, which stretches from Tennessee in the south through West Virginia, Eastern Ohio, Western Pennsylvania to New York. Interestingly, the Utica Shale formation runs under… very deeply under… the already well drilled Marcellus Shale formation. *Financial Times 9.27.11*

**Permian Basin keeps On Flowing:**
The Permian Basin is one of the great granddaddy's of the oil business; first discovered in the 1920's, oil has been produced in the Permian since the last 20's. Over the years it has been thought that as much as 30 billion barrels of crude have come up out of the ground, and there was a time when it was thought that the Permian was about to be depleted entirely. It is now believed that there is perhaps as much crude oil still to be gotten up out of the Permian Basin as has been gotten since its inception if not more. The problem is that this oil is harder to get at and is imbedded deeply in the geological structures. Some even argue that there remains nearly twice as much oil in the Permian as has been tapped heretofore. *Gartman Letter 10.12.11*

**Shale Boom**
The Bakken field of North Dakota and the Eagle Ford Shale of Texas are the two biggest of a host of significant new shale discoveries across North America, including the Niobrara in Colorado, the Marcellus in Pennsylvania, the Woodford in Oklahoma…and even includes enhanced recovery of century old fields like California's San Joaquin valley. *Forbes 7.27.11*

**The Green Fiasco**
Solar panel company, Solyndra, declares bankruptcy, costing US taxpayers at least half a billion dollars. An investment of one of the administration financial backers was propped up by the DOE. *Chicago Tribune 9.18.11*

China targets GE wind turbine business with $15B war chest. Wind turbine market is $70b. China strives to repeat its 2010 coup when China sold more than half of the world's solar panels for the first time. *Bloomberg 10.14.11*

## The Big Picture

The financial debacle on both sides of the ocean is at our doorstep. The director-general of Sweden's Financial Supervisory Authority states that the risks to Europe's bank industry are "rapidly" mounting as the fallout of Greece's debt crisis engulfs the whole region. Europe's debt crisis has reached a "systemic dimension." PIMCO's CEO, Mohamed El-Erian says that European leaders are beginning to recognize the need for Greek bondholders to take bigger losses than previously agreed.

Fitch cuts the ratings on UBS, Lloyds and Royal Bank of Scotland and says that more than a dozen banks may follow, including Bank America, Deutsche Bank, Credit Suisse, BNP Paribas, Societe General, Barclays. In the US, Dodd-Frank financial regulations are still being devised and the uncertainty has had a chilling effect on bank lending.

The 17 European Union members are scheduled to meet on October 23. Europe needs a plan to recapitalize and ring-fence banks and other sovereigns. There are many moving pieces and not a lot of time. *Bloomberg, FT 10.13.11 and 10.14.11*

Starbucks CEO urges fellow business leaders to refuse political contributions to politicians until there is a serious plan to rein in deficits. *Politico 8.16.11*

**A Former Inflation Hawk Advocates Expansionary Money Policy**
Ken Rogoff, an inflation hawk during the Volker Fed, and former chief economist for the IMF, now advocates a loose money, reflationary strategy. Rogoff sees the current US situation as a crisis of excess debt. Rogoff believes there has to be some kind of transfer from creditors to debtors. He believes that the world's major central banks need to acknowledge that a sudden burst of moderate inflation would be extremely helpful in unwinding today's epic debt morass. Moderate inflation around 6% for two years would not clear up the books but it would significantly ameliorate the debt problems making other steps less costly and more effective.

**Emerging Markets**
In 2009, emerging markets became larger than developed countries in terms of purchasing power parity. Emerging markets now drive global real GDP growth. *ISI 8.24.11*

# Follow The Money

**Mergers and Acquisitions**

**Biggest Worldwide Announced Deals in the Third Quarter, 2011**
**Ranked by deal, net of debt as of announced date, in $Billions**


**Summary**

Reflecting weak equity markets worldwide, IPO and M&A markets slowed in the third quarter, 2011. Global M&A volume hit $595.2 billion down 18% from the second quarter, 2011 and down 21% from the same quarter, 2010. The number of deals declined 9% from the prior quarter. Dividend and share repurchase continued apace. *WSJ 10.3.11*


| **Buyer** | **Seller** | **Deal Value ($B)** |
|---|---|---|
| Express Scripts (US) | Medco Health Solutions (US) | $29.1 |
| United Technologies(US) | Goodrich (US) | $16.5 |
| Google(US) | Motorola Mobility(US) | $12.9 |
| BHP Billiton (Australia) | Petrohawk (US) | $12.1 |
| Hewlett-Packard(US) | Autonomy(UK) | $11.7 |
| Nippon Steel(Japan) | Sumitomo Metal(90.3%)(Japan) | $9.4 |
| America Movil(Mexico) | TELMEX(40%)(Mexico) | $6.5 |
| Apax,CPPIB,PSP(US,Canada) | Kinetic Concepts(US) | $6.2 |
| Ecolab(US) | Nalco(US) | $5.5 |
| Peabody Energy,Arcelor Mittal(Australia,France) | Macarthur Coal(89.3%)(Australia) | $4.4 |
| Broadcom(US) | NetLogic(US) | $3.9 |
| Cheung Kong, Li Ka Shing Fdn (HK) | Northumbrian Water(UK) | $3.9 |
| Grupo de Inversiones (Columbia) | ING Lat Am Pension, Life, Invst Ops(Chile) | $3.8 |
| Validus Holdings (Bermuda) | Transatlantic Holdings (Bid 1) (US) | $3.0 |
| Capital One Financial (US) | HSBC US Credit Card (US) | $2.6 |
| BC Partners(UK) | Com Hem (Sweden) | $2.6 |
| King (Japan) | Schincariol(50.45%)(Brazil) | $2.5 |
| Colfax(US) | Charter International(Bid2)(Ireland) | $2.4 |
| Temasek(Singapore) | Festival Walk(HK) | $2.4 |
| Ping An Insurance(China) | Shenzhen Devlpmt Bnk(14.8%)(China) | $2.4 |
| | | **$143.6** |

Source: WSJ/Dealogic 9.30.11