CYPRESS
ASSET MANAGEMENT, INC.

MARKET COMMENTARY **JANUARY 2011**

Stocks closed out the year in strong fashion, as the S&P 500 rose 10% in the fourth quarter and finished 2010 up 15% on the year. Despite the dramatic recovery in equities over the past two years (the S&P 500 gained 26% in 2009), valuations remain reasonable thanks to an equally impressive performance in corporate profits. Operating profits are back to the level of their prior peak reached in 2006-2007 before the financial crisis, and are projected to rise 10% in 2011 to record levels. The S&P 500 currently trades at about 14.5 times 2010 consensus estimated operating earnings of $85 and a little over 13 times 2011 estimates of $95.

While profits are set to reach a new high, stocks remain about 20% below the old highs seen in the second half of 2007 and still well below the level of January 2000. In fact, U.S. nominal GDP and global real GDP have already reached new highs, and U.S. real GDP, corporate profits, and dividends are all on track to make new highs in 2011. Stocks have lagged, despite the big move since March 2009, and trade well below their 60 year average PE of 16.4 cited by Bloomberg. This is not surprising given the two bear markets experienced by investors in the past 10 years, an unprecedented financial crisis, and the well publicized but very real investment risks that remain. But the combination of reasonable valuations and improving prospects for U.S. economic growth in 2011 provide an opportunity for stocks to have another good year.

A High Scoring Fourth Quarter

Stocks moved up in the fourth quarter on a combination of better economic news:

- Pick up in auto sales.
- Continued surge in U.S. industrial production and activity.
- While unemployment remains high at 9.4% we did see some improvement as reflected in employment claims and private sector job growth.
- A liquidity boost as the Federal Reserve began its second round of quantitative easing (QE2 involves the purchase of $600-$900 billion in bonds over a several month period).
- Continued strength in emerging market economies, notably China, India and Brazil but including much of Asia and Latin America.
- Surging world trade.
- Strong corporate profits and cash flows.
- Passage of the $858 billion tax bill extending the Bush Tax cuts and offering other goodies such as allowing businesses to write of 100% of capital investments in 2011.
- Last but not least, a dramatic pick up in mergers and acquisitions activity.

Most of these trends look to be gaining momentum into 2011. As a result, the U.S. economy is now projected to be the only major economy that grows faster in 2011 than in the prior year. Still, 3% growth in the U.S. would be well below the 6.4% growth forecast for emerging markets in 2011. Another factor supporting stocks is the more business friendly, centrist Obama Administration and the Republican congress that emerged from the November elections. These developments are favorable for stocks, for jobs and the economy, and they create a more positive backdrop for investors than we have seen in a few years.

While it is probably too much to hope that we will see enough cooperation to meaningfully address the federal budget deficit and restrain government spending along the lines recently suggested by the bipartisan White House Deficit Commission, other areas of cooperation are possible. Tax reform and simplification is one possibility, and this could include a cut in the corporate tax rate. The U.S. and Japan currently have the highest corporate tax rates in the industrialized world.

Housing is one area that has hamstrung the recovery and did not improve in the fourth quarter. The Case-Shiller home price index has continued to decline, and housing prices could potentially face a further 10% drop nationally given the pending mortgage foreclosure mess. But the threat of a further "collapse" in housing is virtually toothless at this point. Investment in new houses as a percentage of GDP has fallen from 6.3% during the 2005 housing bubble to 2.4% in 2010. Housing simply can't hurt the economy that much any longer and sometime in 2011 should begin to be a tailwind.

2011E Real Global GDP (based on PPP Fx Rates)

	Weight	GDP Growth
U.S.	20%	3%
Eurozone	17%	1.5%
Japan	6%	1%
Other Developed (e.g. Australia, Canada)	7%	2.8%
Total Developed	**49%**	**2.2%**
Total Emerging	**51%**	**6.4%**
Major Emerging Economies:		
China		*9.0%*
India		*8.6%*
Russia		*4.5%*
Brazil		*4.0%*
Total Global	**100%**	**4.2%**

Sources: IMF, ISI Group, BAML

Have The Winds Shifted From Bonds to Equities?

Stocks should be the primary beneficiary of a reallocation of assets out of fixed income. Bonds have enjoyed a 25 year bull market, but the prospect of increasing Federal budget deficits and rising government debt will likely begin to weigh on the bond market some time in 2011. Moreover, continued global growth will exert upward pressure on inflation (e.g. rising oil and food prices) and on interest rates globally. Money is likely to move out of fixed income and into higher risk, higher return assets on a global scale.

As investors search for growth and income, they will discover that dividends are poised to grow much faster than profits in 2011. Dividends should increase almost 20% in 2011, whereas in 2010 corporations sought first to conserve cash and strengthen the balance sheet coming out of the recession and credit crisis. Consequently dividends grew at a lower rate than profits. Now payout ratios are in a position to rise again over the next few years.

Market Risks Remain At Home & Abroad

The European financial crisis remains unresolved and poses the most significant threat to the world economy and to equities. We also face similar challenges here in the U.S. to restrain government spending and reign in growing budget deficits. If we do not act, the market will act for us and that is certainly something none of us want to see.

Higher oil prices and rising food prices pose a threat to the global recovery and to the still shaken consumer. Already concerned about an overheating economy, China and the other major emerging markets are taking measures to cool growth and restrain inflation. China is the primary engine of global growth in today's world economy and the primary demand driver for most commodities and resources. Should China be unsuccessful in moderating its economic growth, or "over-tighten", the world economy would sustain a serious setback.

U.S. state and local fiscal problems also represent a drag on the recovery and future growth. State and local government solvency, however, is not something that makes any economic or policy sense for the federal government to guaranty or "bail out". As the economy strengthens, state tax receipts and coffers should improve but it remains a concern that could flare up and intensify periodically.

Dan Japhet, Sr.

Finally, we are saddened by the loss of our friend, colleague and partner, Dan Japhet, Sr. Dan was a partner in Cypress Asset Management from inception. He was a unique man in today's world; he had a wellspring of optimism that never faltered and a genuine concern and interest in others from all walks of life. Even when it rained, Mr. Japhet walked on the sunny side of the street. Toward the end of his long battle with cancer, he would visit on a regular basis, neatly appointed in sartorial splendor including his trademark bow tie. He would always have a good question about the markets, an interesting observation about businesses and, most importantly, a kind word of encouragement. His presence lit up the office, we were all left a little better for his time with us. Dan loved his family, he enjoyed the competition and camaraderie of hunting and fishing, and he relished the company of others. We are assured that in his new home, he is in a better place where the fishing is great, the quail are fat and plentiful, his tennis game is perfect, stocks all grow to the sky and, the food, wine and company are extraordinary. We will always remember Dan and his salutation "go with good cheer." God bless you, Dan.

Cypress Asset Management – December 2010

Good News

China

- China begins to flex economic power
- World Bank issues 1st Yuan bonds in Hong Kong 1/5/11
- Bank of China announces trading of Yuan in the US, expanding from trading in Hong Kong, last year. *WSJ 1-12-10*
- China supports a stable euro and won't reduce its holdings of European bond. *Bloomberg 10-3-10*

Chinese M&A

- After some botched M&A efforts of foreign companies, Chinese companies begin to announce some non-mainland acquisitions. ChemChina buys the world's largest generic pesticide manufacturer. Sinopec acquires $2.5 b in Argentine oil and gas assets. *WSJ 12-31-10*

European Debt Financings Ongoing:

- There is demand for Portuguese, Spanish and Italian debt in early 2011. *Marketwatch 1-12-11*

India:

- Airbus announces largest order in commercial aviation history with Indian budget airliner, IndiaGo

Wall Street Crisis of Trust:

- Tension on Wall Street Eases
- Goldman Sachs to provide more disclosure on proprietary trading *WSJ 1-11-10*
- Jamie Dimon says JP Morgan will boost its dividend, 2Q 2011. *WSJ 1-11-10*

A More Business Friendly US Congress:

- November 2010 election sweeps in a majority of Republicans with a pro-business, lower spending, lower taxes, and less regulatory agenda.

U.S.

- Vehicle sales picking up, forecast to increase 14% in 2011 to over 13 million units (still well below pre-recession levels) *WSJ*
- U.S. land based oil and gas exploration is booming and the rig count is up 42% y/y.
- Information Technology spending and profits at record levels worldwide, as U.S. tech companies lead the way.

Bad News

China

- China has reduced second half export quotas for rare earth minerals by 72%. Prices for these minerals soar. *Bloomberg*
- China begins to flex military might
- Test flight of new stealth fighter coincides with visit of U.S. Defense Minister. *WSJ 1-12-10*
- Chinese developing new anti-ship ballistic missile capable of attacking carriers. *Fox 8-10-10*

European Economic and Fiscal Struggles Continue:

- Spain Secures Passage of Austerity Budget. *Bloomberg 10-19-10*
- Portugal's Deficit Target in Peril. *Financial Times 10-23-10*
- Greece will slash thousands of public-sector jobs. *WSJ 10-23-10*
- Hungary unveiled a new budget plan that implements temporary tax increases. *WSJ 10-19-10*
- Hungary is planning to cut up to 50,000 jobs in the public sector. *Bloomberg 10-21-10*
- The U.K. plans to cut 490,000 public-sector jobs. *Financial Times 10-21-10*
- France faces more strikes over pensions. *Financial Times 10-23-10*
- European debt spreads widen for the weaker countries:
  Debt spread over Germany over the last year:
  Portugal: was 50-60 bps, now about 400 bps
  Spain: was 50 bps, now about 270 bps
  Italy: was 60 bps, now about 200 bps *Bloomberg 1-11-11*

Wall Street Crisis of Trust:

- Citibank Settlement shows low cost of lying to markets. Citigroup will pay $75 million fine to settle charges that it misled investors about its exposure to the subprime markets in 2007. *CNBC*

U.S. - Jobs, Wages and Employment Remain Persistent Problem

- U.S. unemployment rate stuck around 9.5%; U.S. economic growth currently running well below optimal capacity; deflation remains a threat. *ISI Group*
- U.S. offshore drilling moratorium and regulatory uncertainty likely to cost more jobs than BP oil spill and result in lower future U.S. energy production and tax revenue…then there is the damage to one of the few industries American companies still dominate. *Lex Column, Financial Times 7-13-10*
- The average federal worker made more than twice the average private sector worker in 2009: $123,000 vs. $61,000. *U.S. Commerce Dept. via Hulbert Investor Letter 8-17-10*

Good News (continued)

Australia

- "Australian employment surged past all expectations in September, adding 49,500 new jobs, more than double the forecast (equivalent to 600,000 U.S. jobs).
Reuters 10-7-10

IPO'S

- AIG raised a record $17.8 B in IPO for AIA (AIG Asian Life Insurance Sub)

Bad News (continued)

U.S. Housing Market Woes Continue

- JP Morgan reports that $2 trillion of the $6 trillion of U.S. mortgages and home-equity loans that were securitized during the height of the bubble, from 2005-2007, are likely to go into default. Says housing bust will likely cause losses of $1 trillion. Projects bond holders will absorb most of the losses. *Bloomberg*
- Foreclosure moratorium mess is a threat to housing recovery. *WSJ*
- Case-Shiller Housing Price Index declines four consecutive months *(S&P/Case-Shiller July-Oct 2010)*

Pick 'Em – Could be Good, Could be Bad

Quantitative Easing 2:

- QE2 Boosts Stocks and Prospects for Economic Growth in 2011: "The idea behind quantitative easing is you buy government paper that's held by financial institutions or individuals. And then they have the money. And then they go out and buy some other financial assets, stocks. And they drive up the value of those other financial assets so we get an increase in the value of financial assets which means an increase in the value of lots of peoples' household wealth. And the idea is if household wealth goes up, then that will be a spur to spending…If their assets go up in value, if the stocks and bonds they hold go up in value, they will be inclined to feel wealthier and more confident about the world. That's the theory." *John Snow, Former U.S. Treasury Secretary on PBS Nightly News 10-11-10*

The Helicopter Money Has to Go Somewhere:

- More U.S. stocks are paying dividends that exceed bond yields than any time in the last 15 years. *Bloomberg*
- Rates on inflation-protected Treasury Bonds carry a negative yield for the first time in history. A combination of low interest rates and growing fears or rising prices enabled the U.S. to sell TIPS with a negative yield for the first time ever. *Bloomberg and WSJ*
- The yield on the 10 Year US Treasury has increased from 2.5% to 3.35% since October 8, 2010.
- Merrill Lynch predicts new round of corporate leveraging. Quantitative easing and investor preference for debt over equity results in large gap between earnings yield and after tax debt yields. Investors overvalue debt and undervalue equity. Historic incentive for debt issuance to buy back equity. IBM announces $10 billion debt issuance for stock buyback.

New Gold Standard:

- Leading economies should consider readopting a modified global gold standard to guide currency movements, argues the president of the World Bank. *Financial Times 11-8-10*

Animal Spirits:

Private Market Transactions Heat Up

- November 2009: Elevation Partners invests $90 million in Facebook at $9 billion valuation
- November 2010: early Facebook investor, Accel, sells 17% of Facebook for $516 million, $35 billion valuation
- January 2011: Goldman Sachs and DST among investors who invest $500 million for 10% of Facebook, $50 billion valuation. *Source: Techcrunch.com*
- January 2011: Groupon raised $950 million from well heeled venture investors making it the largest amount ever raised by a startup. Groupon reportedly turned down a $6 billion purchase offer from Google in December, 2010.
Source: businessinsider.com

Follow The Money

Mergers and Acquisitions

Biggest Worldwide Announced Deals in the Fourth Quarter, 2010
Ranked by deal value, net of debt as of announced date, in $ billions

Buyer	Seller	Deal Value ($B)
Fed. State of Baden-Wurttemberg (Germany)	Energie Baden-Wurrttemberg	13.9
AXA/AMP	AXA Asia-Pacific	13.9
Jelas Ulung (Maylasia)	PLUS Expressways (Malaysia)	8.3
Singapore Exchange (Singapore)	ASX (Australia)	8.3
Uralkali (Russia)	Silvinit (Russia)	8.2
Caterpillar (U.S.)	Bucyrus (U.S)	7.7
Bridas (Argentina)	Pan Am Energy (Argentina)	7.1
Vimplecom (Russia)	Weather Investments (Italy)	6.6
TD Bank (Canada)	Chrysler Fin (U.S)	6.3
Pepsi (U.S.)	Wimm-Bill-Dann (Russia)	5.8
Cliffs Natural Resources (U.S)	Consolidated Thompson Iron Mines (Canada)	4.9
VW (Germany)	Porsche (Germany)	4.6
Simon Property (U.S.)	Capital Shopping (UK)	4.4
HCP (U.S.)	HCR Manor Care (U.S)	4.4
NE Utilities (U.S.)	NSTAR (U.S)	4.2
Bank of Montreal (Canada)	Marshall & Ilsley	4.1
Hana Financial (SK)	Korea Exchange Bank (SK)	4.1
KKR, Centerview, Vestar	Del Monte (U.S.)	3.9
Rio Tinto (UK)	Riversdale (Australia)	3.8
Pfizer (U.S.)	King Pharma (U.S.)	3.6
Chevron (U.S.)	Atlas Energy (U.S.)	3.6
Vallar (UK)	PT Bureau Coal (Indonesia)	3.6
Carlyle Group (U.S.)	Commscope (U.S.)	3.5
3i, Morgan Stanley, Star Cap (U.S.,UK)	Eversholt (UK)	3.4
Community Health (U.S.)	Tenert Healthcare (U.S.)	3.3
Walter Energy (U.S.)	Western Coal (Canada)	3.2
Oaktree Cap, Ares Mgmt (U.S.)	EXCO Resources	3.1
ABB (Switzerland)	Baldor (U.S.)	3.1
GE (U.S.)	Dresser (U.S.)	3.0
TPG, Leonard Green (U.S.)	J Crew (U.S.)	3.0
Korea Devpmt Bank (SK)	Daewoo Engineering (SK)	2.8
EMC (U.S.)	Isilon (U.S.)	2.6
Sinopec (China)	Occidental O&G (Argentina)	2.5
Shuanghi (China)	Henan Shuanghui I&D (China)	2.5
Emp. Prov. Fund (Malaysia)	PLUS Expressways (Malaysia)	2.4
AP Muller-Maersk (Denmark)	SK do Brasil	2.4
Henan Shuanghui I&D (China)	Henan Luohe Shuanghui (China)	2.4
AGL Resources (U.S.)	Nicor (U.S.)	2.4
Bank of Nova Scotia (Canada)	Dundee Wealth (Canada)	2.4
Want Want China (Taiwan)	China Network (Taiwan)	2.3
InterRAO (Russia)	OGK (Russia)	2.3
Carlyle Group (U.S.)	Syniverse (U.S.)	2.3
Origin Energy (Australia)	Country Energy (Australia)	2.3
Shanghai Friendship (China)	Shanghai Bailian (China)	2.2
Attachmate (U.S.)	Novell (U.S.)	2.2
Thermo Fisher (U.S.)	Dionex (U.S.)	2.2
Novorossissky Comm (Russia)	Primorsk Sea Trade (Russia)	2.2
Investor Group (U.S., Australia, UAE)	Port of Brisbane (Australia)	2.1
Yildizlar (Turkey)	Toroslar (Turkey)	2.1
ATT (U.S.)	Qualcomm Spectrum	1.9
Panasonic (Japan)	Sanyo Electric (Japan)	1.9
Total		$209.30