CYPRESS
ASSET MANAGEMENT, INC.

MARKET COMMENTARY **July, 2014**

Strong Second Quarter: Stocks follow the Lead of a U.S. Economy Back at Absolute Highs

The S&P 500 posted a 7% total return in the first half of 2014, outpacing the DJIA (2.6%), Russell 2000 midcap index (3.2%), and the NASDAQ Composite (6.2%). While valuations are no longer at the bargain levels of a few years ago, stocks are also not expensive at 16.5 times 2014 and 15.0 times 2015 consensus estimates for S&P operating earnings.

Our outlook for the equity markets remains constructive. Fed policy remains highly accommodative and new Fed chair Janet Yellen is even more dovish in her monetary views than former chairman Bernanke. The U.S. economy continues to improve but is far from taking off. Growth levels are likely to remain historically modest, but evidence of a self-sustaining economic recovery continues to mount. A record number of Americans are now employed, unemployment claims have returned to normal levels, and even the stubbornly high unemployment rate is approaching pre-crisis levels. Other measures of economic health and progress are even more tangible. Vehicle sales, railcar loadings, corporate dividends, U.S. hotel revenue, and Federal government receipts are all at new highs and trending higher.

The New Normal

Despite the ongoing recovery, plenty of slack remains in the U.S. economy. GDP growth and domestic production are well below capacity, and not only does unemployment remain elevated, but the labor force participation rate is at an historic low. Consequently, wage growth has been anemic and inflationary pressures have not begun to build. As a result the Fed should remain accommodative for some time. The first hike in short term rates is not expected until mid-2015 at the earliest, and from there will only increase gradually going forward. Long term interest rates should remain relatively low.

The Fed views the slack in the economy as an "output gap" and is concerned that it threatens to become structural. Rising levels of government debt and entitlement obligations, a highly competitive global economy, the trend of technology and machines increasingly replacing human labor, slower population growth all pose structural challenges to the economy. Chairman Yellen has made clear she believes it will take "an extraordinary commitment for an extended period of time" to return the U.S. economy to optimal production and employment levels.

The term "new normal" has been coined by economists and others to describe an environment of slow but sustainable growth, low inflation, and low interest rates, ultimately reliant on productivity for real economic growth. The good news of the new normal is that we may be years away from the buildup of the business cycle excesses which classically lead to recession. The "new normal" also exacerbates the typical skepticism which greets an economic recovery and bull market. The economy and equity markets continue to be viewed skeptically, if not with outright mistrust, and with little confidence that their recoveries are sustainable. So the U.S. economy may be in pretty good shape and the markets at new highs in 2014, but the mood of Americans at home and of investors remains very subdued. This is understandable given all that has occurred in a historic beginning to the new century: structural changes in our economy represented by the new normal; rising geopolitical risk and regional conflicts and a perception of waning American global hegemony; and for investors the lost decade of 2000-2009 when the market went through two bear markets and an epic financial crisis.

A Historical Perspective on Bull Markets

Strangely, the new normal and the foreboding that accompanies it, provides a positive backdrop for stocks and fundamental support for a secular bull market. Having begun in early 2009, the current bull market could last another ten years. We have discussed the possibility of a long economic expansion given slower growth (a far cooler engine running at less than high speeds) and considerable slack in the economy, some of which may be structural. Historical market patterns, however, also lend support to the idea that the current bull market may have years left to run. This is the view of Jeffery Saut, a long time investment strategist at Raymond James:

> *Based on historical evidence, stocks typically enter a very long expansion after emerging from a period of negative 10-year returns.* (Note, in 2009, the trailing 10 year annualized return on the S&P 500 stood at -1%). *We found that on average, these periods last for roughly 15 years, and deliver average annualized returns of about 16%*

In fact, following the tumultuous period from the mid-1960s through the 1970s, just such a secular bull market emerged. From 1982-1999 (18 years) the S&P 500 compounded at an annual rate of about 17% and experienced only one year (1990) in which the market did not achieve a positive total return. In the preceding periods, the bear market which ran from the 1930s and the great depression through WWII was followed by a 20 year secular bull market.

Cypress Strategy: Maintain Focus and Investment Discipline

At Cypress our investment focus continues to be on high quality companies that can deliver solid and sustainable growth and are committed to returning value to their shareholders. As we are now more than five years into a bull market, investment discipline and maintaining a proper balance in the portfolio are the basis for preserving value and promoting durable returns. Given that the market is a volatile beast, our portfolios are inherently conservative. We continue to believe in the virtues of patient long term investing, and the benefits of "slow money" as contrasted to the game of "fast money" which inevitably becomes increasingly enticing to investors as a bull market progresses. Hot pockets in the market and hot stocks where valuation and long term fundamentals don't make sense can certainly be found in the current market, and we have commented on these in recent letters. But they remain of relatively limited size and scope, and not alarming in the perspective of the broader market.

We believe our portfolio is better positioned and stronger in its components than at any time in our firm's history. This at least gives us no small measure of comfort and confidence in an uncertain world, but a world where the odds should continue to favor the long term equity investor.

MARKET OUTLOOK

Positives

U.S. Economic Fundamentals Improving:

Housing in slow recovery but should enjoy a sustainable multi year recovery. Home prices enjoy steady increases over last 24 months but still affordable; home inventories at historical low levels. Mortgage rates rise from lows but remain attractive. *Commercial real estate prices also increasing.*

Strong Domestic Auto Market
Auto sales almost all the way back from recession low. Forecast to hit @ 16.5 -17 million units in 2014.

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.
- Low natural gas prices continue to benefit U.S. consumers and manufacturers: at around $4, U.S. natural gas prices remain far below the $14 world average. Cheap natural gas a competitive advantage for U.S. manufacturers.

S&P 500 & Dow Jones hit record highs in 2014

- Monthly inflows into equity mutual funds positive throughout 2013 and into 2014

Attractive Equity Fundamentals:

- Strong Corporate Fundamentals: Cash, Cash Flow, and Profits at record levels and still growing, *but earnings growth has slowed* to mid-single digits. Could see profit growth reaccelerate in 2H2014.
- Over $4t in corporate cash combined U.S. & Japan, up 11% y/y, and roughly equal in size to the Fed balance sheet!
- Strong Dividend Growth: Dividends set to surge 10%+ in 2014 and are now 25% above prior peak. Even so, at 31% the payout ratio remains near historical lows, i.e. still lots of room to grow.

Synchronous Global Recovery:

- For first time in recent years, major global economies of U.S., Europe, Japan and China all growing at the same time, albeit very modest growth.

Stimulative Monetary & Fiscal Policy Continues:

- 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 30 months).
- Accommodative Fed, ECB & BOJ
- Fed continues to emphasize it expects to keep short term interest rates exceptionally low well into 2015 and then raise them only gradually.

Commodity prices have cooled providing a boost to consumers and manufacturers, and obviously positive for inflation outlook (e.g. oil, copper, corn all flat to below year ago levels; natural gas is off its lows but still below its 2011 average).

The Great Rotation:

- The rotation out of bonds into equities is only in the early innings, and could be a significant tailwind for equities over the next several years.

M&A Boom: Deals, deals, and more deals

- Reflecting rising business confidence and lots of liquidity, there has been an historic surge in corporate deals. ISI reports a tally of 300 deals totaling more than $2 Trillion since the beginning of February.

Negatives

Global Growth Remains in Slowdown:

- Euro Zone Recession extends well into its second year, but may finally be lifting. Recent signs of economic improvement raise hopes for recovery in 2014.
- 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.

Fed Tapering and Fall 2014 End to Asset Purchases:

- Fed Policy remains data dependent but asset purchases should end Oct. 2014, monetary policy should remain accommodative.

Tax & Regulatory Headwinds

- Higher tax rates and healthcare costs impact consumer spending.

Macro Secular Concerns:

U.S. Social Security and Medicare on unsustainable trajectory: 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.

Will we ever grow enough?
Remains to be seen whether the historic stimulus programs in the U.S., Europe, Japan and elsewhere in the developed world will ever produce growth that is fast enough to handle the debt level and, hopefully, reduce the rising debts and obligations of our entitlement and social welfare programs.

Geopolitical Risk: A rise of regional conflicts and instability

- Middle East: Egyptian turmoil, Civil War in Syria and Iraq, Iranian nuclear crisis.
- Russian and Ukrainian tensions remain high, fighting continues in Eastern Ukraine.