C Y P R E S S

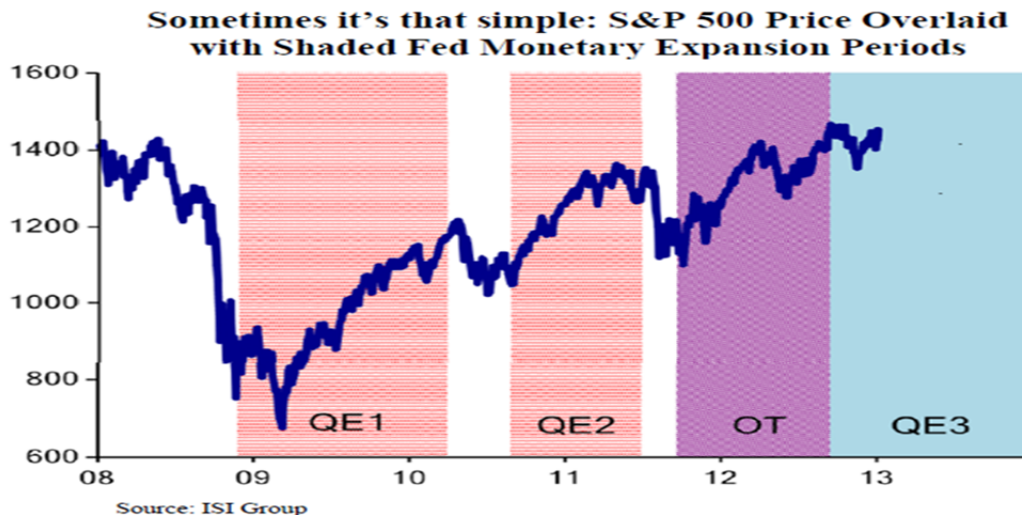
ASSET MANAGEMENT, INC.

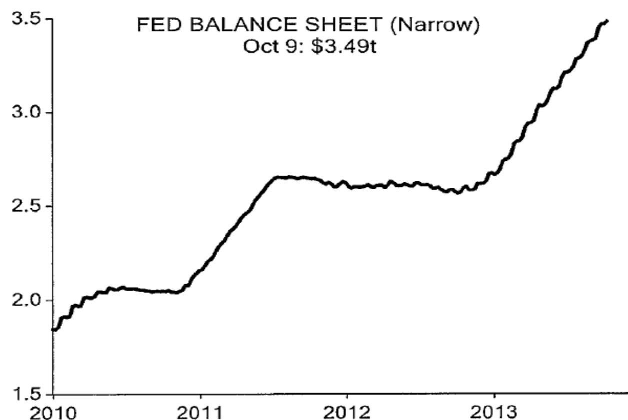
MARKET COMMENTARY **October 2013**

Q3 2013: Market Returns Still Favor Equities

Stocks continued their advance in the third quarter as the S&P 500 rose almost 5% despite ongoing macro concerns over Fed tapering and the Washington debt ceiling/budget stalemate and potential for a U.S. default on its debt obligations. The S&P 500 finished the quarter up 19.7% (total return) year to date while bonds again struggled. U.S. Treasury bonds declined another 2.5% and are now down 10.5% on the year, while investment grade corporate bonds were slightly positive for the quarter, but remain down 2.5% on the year.

A stimulative monetary policy, quantitative easing (QE) and the unrelenting increase of the Federal Reserve balance sheet, is supporting modest economic growth despite fiscal policy headwinds. QE is also providing a powerful and steady lift to both stocks and housing prices. When macro concerns over issues such as the Washington budget stalemate dissipate, it creates the potential for a significant year-end rally. The slow pace of core inflation is also likely to encourage continued QE and will keep upward pressure on stock prices and real estate.





Global Growth

The return of "synchronized" global growth is a positive fundamental development. The U.S., China, Japan, and now the Euro Zone are finally moving in the same direction- albeit very modest but still positive growth- for the first time in three years. This is reflected in the recent sharp 3Q rise in the Baltic Freight rate. The global shipping benchmark has surged in the past three months in response to a pickup in global trade. Corporate earnings should also get a lift in 2014 from the still nascent recovery in the global economy. Profit growth has decelerated with the global economy over the past four quarters and is currently running at only about 5%.

Longer term, it remains to be seen whether the historic monetary stimulus programs in the U.S., Japan, Europe, and elsewhere will ever produce growth in the developed world that is fast enough to handle its debt level. Sustainable growth depends on actually reducing, over time, the rising debt level and obligations of our entitlement and social welfare programs (i.e. reducing them as a percentage of overall GDP before a tipping point is reached which takes fiscal policy out of our hands and results in financial crisis).

Dividend Surge

Of particular significance to our investors and to longer term investors, dividend growth has surged over the past year. Even though corporate earnings are only up 5% y/y, dividends grew 15% in the 3Q. The dividend payout ratio increased (corporations decided to pay out more of their total profits to shareholders in the form of dividends), although the payout ratio remains at historically low levels. The payout ratio has averaged about 50% during the past 75 years, but saw a steady decline beginning in the mid-1990s. It is currently running at 32%, still exceedingly low by historical standards and leaving plenty of room for future growth. Dividend growth is further supported by record high levels of corporate cash flow and cash on the balance sheet. In a slow growth, low rate environment we would not be surprised to see a normalized payout ratio rise towards 40% over the next decade.

Dividends provide a predictable source of steady and growing income, buffer market volatility, and represent a major source of market returns over the longer term. Academic studies attribute over 40% of the total equity market return to dividends (more if these dividends are reinvested). All of this is important to most individual investors. Dividends are also more durable than stock prices and even earnings, both of which tend to fluctuate over shorter periods of time and are more subject to market volatility and economic ups and downs.

The value and attractiveness of solid dividend growth stocks is likely to increase over the next few years given a continued low rate, slow growth global environment. Dividends provide not only a means to generate income in a low yield environment, but importantly unlike a bond coupon, have the ability to grow over time. We will continue to emphasize dividend and dividend growth in our portfolios: high quality companies with durable business franchises that can adapt to a changing global economy. A diversified portfolio constructed on solid fundamentals provides a foundation for both future dividend growth, based on underlying growth in free cash flow and profits, and the potential for greater capital appreciation.

An increasing income stream and good prospects for capital appreciation will become even more coveted when our economy and interest rates normalize. Rising rates could result from better real economic growth, monetary inflation, or a combination of the two. The transition to higher rates could take years to play out or it could occur very rapidly. We believe that long term Cypress investors will continue to be rewarded, as we expect dividend growth and "return of capital" to shareholders to outpace earnings growth over the next few years.

Speculative Market Drivers: QE and the Animal Spirits

One noteworthy side effect of "easy money" and more than four years of unprecedented Fed monetary expansion is its speculative impact on markets. QE has been a rising tide that has lifted stocks broadly, and has generated a flow of fast money into speculative stocks, concept stocks, emerging growth and small cap stocks, momentum stocks, optimistically valued high flyers, etc. The result of the rise of fast money is pockets of silly valuation in the market. Examples include the current biotech/healthcare mania (multi-billion dollar valuations for companies with a promising compound or gene therapy but little revenue), cloud software stocks (e.g. SaaS or software as a service web-based providers where again multi-billion dollar market caps compare to modest revenue and rather intense competition from existing enterprise software firms to burgeoning new startups and technologies), and Chinese small cap and internet stocks where little is really known other than an appealing sounding business proposition (if the story and numbers are as purported) to go along with an ADR listing on a U.S. exchange. No, we are not talking about another internet technology bubble like 1999-2000 or a new housing bubble, but it is something to keep our eye on and a reminder to maintain investment discipline and perspective. The great monetary experiment has begun to rekindle the animal spirits, and will likely not end quietly. Considerable fireworks should be in store for markets in the years to come.

MARKET OUTLOOK

Positives

U.S. Economic Fundamentals Improving:

Housing is strong and should enjoy a sustainable multi year recovery. Home prices enjoy steady increases over last 18 months; mortgage rates rise from lows but still attractive. Housing price improvement may be even more important to overall economy than housing starts. U.S. commercial real estate prices also increasing.

Strong Domestic Auto Market
Auto sales up 66% from 2008 recession low, reach recovery high of about 16 million units in Q3.

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.
- Record low natural gas prices benefit both U.S. consumers and manufacturers: U.S. natural gas prices remain under $4, still far below $12 world average. Cheap natural gas a competitive advantage for U.S. manufacturers.

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

- 2013 has been a year where several months experienced strong inflows into equity mutual funds. January 2013 had a record inflow of $66B and September 2013 was also a strong month with over $48B in inflows.
- Number of IPO's on tap to reach the highest level since 2007. Total IPO proceeds during 3Q2013 were $12B, compared to $13B in 2Q2013 and $7B in 3Q2012, an increase of 76% y/y. 81 companies entered the IPO registration process in the 3rd quarter, a dramatic y/y increase compared to 39 companies during the same period last year.

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.
- Strong Dividend Growth: Dividends surge 15% in 3Q2013 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 Wave:

- 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 24 months).
- Accommodative Fed, ECB & BOJ
- *Appointment of Janet Yellen as next Fed Chairman insures continuity with Bernanke and current stimulative policy.*

Commodity prices have cooled providing a boost to consumers and manufacturers, and obviously positive for inflation outlook (e.g. natural gas, copper, corn all below year ago levels).

The Great Rotation:

- Have we reached a tipping point where investors re-allocate capital out of fixed income and into stocks?
- Bond Funds turned sharply negative in June as concerns grow over what happens when "bond bubble" and artificial low rate environment comes to an end while equity inflows have turned positive in 2013.
- Early innings so far, but it's possible over next few years there could be a significant rotation out of bonds into equities.

Negatives

Washington Stalemate over Government Debt Ceiling & Federal Budget currently impacting economy, confidence and markets; global fears over potential for U.S. default on its debt.

Global Growth Slowdown extends into 2H2013:

- Euro Zone Recession extends well into 2nd year, but recent signs of economic improvement raise hopes for recovery.
- China economic challenges: China struggles to transition to a more consumer demand and domestic driven economy.
- BRICs sputter: Emerging market growth slows in from China to India, Russia and Brazil.

Fed Tapering:

- Concerns remain surrounding Fed tapering their asset purchases, rising interest rates, and impact of winding down of monetary stimulus program
- Tapering remains data dependent and domestic growth is not accelerating.

Tax & Regulatory Headwinds

- Federal Sequestration hurting growth
- Effect of first full year of higher tax rates
- Carbon, Obamacare, and Financial regulations hampering business investment.

Macro 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.

But 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.

Middle East - Egyptian turmoil Syrian Civil War, & Iranian nuclear crisis