CYPRESS
ASSET MANAGEMENT, INC.

MARKET COMMENTARY **January, 2014**

A Big Year for U.S. Equities:

The fourth quarter capped an exceptional year for U.S. equities in 2013 and a remarkable multi-year recovery from the market lows of the financial crisis in early 2009. The S&P 500 gained 10% in the 4Q and 29.6% for the full year. U.S. equities outperformed almost all other markets and asset classes in 2013, easily surpassing the total return for global equities (MCSCI world ex-U.S. was up 13.3%). Investors did not fare nearly so well and actually lost money in emerging markets (-5.0% in USD), long term Treasury bonds (-12.7%), municipal bonds (-2.6%), investment grade bonds (-1.6%) and gold (-27.8%).

After the best year in 16 years and record highs for the DJIA and the S&P 500, we expect a more subdued year for equities and more typical returns. The fundamental backdrop for stocks remains positive, actually better than it has in a number of years, and it is not unreasonable to expect a 7-11% total return from the S&P 500 for 2014. This is based on four major supporting pillars: a strengthening U.S. economy, an accommodative Federal Reserve, valuations that remain reasonable, and a continuing rotation out of bonds into equities as interest rates rise. In addition to these fundamental supports, the "technical" trend has been that big years for the S&P 500 typically carry over into the following year. According to ISI market research, the year following 28+% total returns have averaged better than 16% since 1950.

2013 Equity Market Returns*	%
United States S&P 500	**29.6**
Dow	26.5
Nasdaq	38.3
MSCI World Index	**21.0**
MSCI Emerging Markets	**-5.0**
MSCI World Ex U.S.	**17.8**
Europe (DJ Euro Stoxx)	**17.3**
Brazil (Bospova)	**-15.5**
Japan (Topix TSE)	**56.7**
China (Shanghai Comp)	**-6.8**
Barclays Bond Index Returns	**%**
Long Term Treasury	**-12.7**
Intermediate Term Treasury	**-1.3**
Muncipal Bond	**-2.6**
U.S. Corporate Investment Grade	**-1.6**

*Index returns are price appreciation only

Commodities	Units	Dec-12	Dec-13	% Change
WTI Crude	$/Bbl	91.82	98.42	7.2%
Brent Crude	$/Bbl	110.68	110.82	0.1%
Nat Gas	$/Mmbtu	3.365	4.34	29.0%
Gold	$/troy oz	1675.8	1203.8	-28.2%
Copper	$/lb	369.3	339.45	-8.1%
Iron Ore Fines	$/net ton	136	134.2	-1.3%

Economic and Market Outlook 2014

GDP Growth Forecasts versus S&P Earnings	2012	2013e	2014e
Global GDP Growth (y/y rate)	3.2%	3.0%	3.5 - 3.75%
U.S.	2.8	1.9	2.7 - 3.1
Euro Area	-0.06	-0.4	1.0
Japan	2.0	2.0	2.0
Developing Asia	6.4	6.3	6.5
China	7.7	7.6	7.3
Latin America	2.9	2.6	3
Emerging Market & Developing Economies	4.9	4.6	5.1
S&P 500 Aggregate EPS	103.6	109.5	117-120
Earnings (y/y rate)	5.0%	5.7%	7.5 - 10.0%

Sources: IMF, ISI Group, BAML

Pillar 1 - The Road Forward to a Normal Economy

The economic backdrop for stocks is more positive than it has been in many years. The U.S. economy is improving broadly and finally may have reached a point in its recovery where growth is self-sustaining.

- The housing market is in a multi-year uptrend and fundamentally strong. Home prices have steadily increased over the past 24 months but remain affordable, and home inventories are at historically low levels.
- The domestic auto market has recovered and is healthier than it has been in some time; the automotive and housing industries both have a significant multiplier effect on the economy.
- The renaissance in U.S. energy and oil and gas production has put the U.S. on a path to energy "independence" and is providing a competitive advantage to U.S. manufacturing.
- The U.S. financial and banking system has been repaired and recapitalized, and is much stronger fundamentally than its global counterparts. Bank loans have gradually increased over the past two years, but according to ISI have "surged" in the last few weeks.
- Employment is slowly improving and the unemployment rate is down from 10.0% in 2009 to 6.7% today.
- The U.S. Consumer is in surprisingly good shape: Household Net Worth is at a record high, and the Household Debt Service Ratio (debt payments as a % of disposable income) has collapsed to a 35 year low, aided in no small part by today's artificially low interest rates. This should bode well for consumer spending, which has already proved more resilient than expected post financial crisis.
- Inflation remains low, below 2%, and commodity prices well contained. In the wake of the financial crisis, central bankers remain more concerned over persistent deflation.
- The government sector should represent less of a financial drag on the economy this year. The recent "Ryan-Murray" congressional budget agreement softens the impact of the Federal Sequestration, and the Federal budget deficit is forecast to be down to about 4% of GDP in 2014 from a high of almost 10% in 2009.

Better growth naturally leads to higher interest rates, and higher rates are a particular concern to the financial markets. As a still recovering U.S. economy "normalizes" we should expect to see interest rates, inflation, employment, and GDP growth approach normal and typical levels. If interest rates are going up for the right reasons, stocks can do well. Jeffrey Saut of Raymond James points out that between 1946 and 1964, despite the increase in interest rates from 2.1 to 4.5%, the DJIA soared from 170 to 731.

Despite improving fundamentals, the U.S. economy is certainly not "taking off". The global recovery, while seeming to have turned a collective corner in late 2013, remains at risk as evidenced by the accommodative policy actions of global central bankers. Monetary policy remains proactive in fighting "deflation" and providing support for the moderate but synchronized global expansion taking shape in the U.S., Europe, Japan, and China. For equities, where the biggest risk is weaker growth and lower rates not stronger growth and higher rates, the sustained commitment to an "easy money" policy will mitigate the risk of a severe contraction in asset prices.

Though the global economy is not threatening to break out - Eurozone growth forecast of only 1% and moderating Chinese growth as it transitions to a more consumer driven economy - these types of moderate but broad based expansions tend to be self-reinforcing. If the global economy picks up steam during 2014, this will boost U.S. growth and be a positive for the equity markets.

Pillar II – Behind Taper Headlines the U.S. Fed Remains Accommodative

The Fed has begun to taper the pace of its asset purchases, and will likely make further reductions over the course of 2014. The Fed has emphasized that tapering will be implemented in measured steps and is data dependent. By any measure, the monetary policy remains highly accommodative, and the Fed is still set to increase its balance sheet by $400-500 billion or 10-12% in 2014. More importantly, it has pledged to keep short-term interest rates exceptionally low well into 2015 and then raise them only gradually. As we have discussed before, equity prices are tightly correlated to monetary policy and liquidity. Easy money should remain a key support to "risk assets" over the next twelve to eighteen months.

Pillar III - Reasonable Valuation Though Equities No Longer Cheap

Equity valuations remain broadly in line with the historic median P/E valuation of about 16.5X (similar to the 60 yr. average P/E). Given an outlook for stronger 2014 GDP growth in the vicinity of 3%, we believe consensus forecast S&P 500 operating earnings of $118-$120 are achievable. This represents acceleration in profit growth of 8%, up from 5.5% in 2013. If we get no multiple expansion in 2014, and simply continue to trade at 16.5 times 2014 operating earnings estimates, it implies a price target for the S&P 500 of roughly 2,000. This would imply a total return of 9-11%. Given the continued acceleration of earnings growth, it is noted that there is a reasonable possibility of P/E expansion.

Dividend growth should continue to outpace earnings growth in 2014, given historically low payout ratios, high levels of cash on the balance sheet, and strong corporate fundamentals. This is supportive of equities and boosts the total return.

Pillar IV- The Great Rotation

Interest rates should rise as the economy strengthens in 2014, forcing money out of fixed income and into equities and money market funds. The rotation out of bonds into equities is likely only in the early innings given the 30 year bond bull market from 1980-2012 and the unprecedented surge into fixed income from 2007-2012 stemming from the financial crisis. Thus far money moving out of fixed income has gone roughly 60% into money market and 40% into equities. This indicates the rotation has been restrained as investors remain cautious and skeptical about the economy and equities.

Cypress Portfolio Strategy and a Word of Caution about Market Risks:

The investment style at Cypress is one that favors larger, proven companies with significant global exposure, dominant market shares, high quality and growing earnings, and above average balance sheet liquidity. These companies produce more predictable cash flow and grow their businesses at reasonable rates over long, investable periods of time. Generally, the companies we invest in pay a healthy and growing dividend that becomes a meaningful part of the total return to long term investors. Our conservative oriented investment style produces investment results that should be significant, sustainable and consistent over cycles.

One of the things our investment style is not designed or likely to do is outperform when the market experiences a rare outsized return. The total return for the S&P 500 in 2013 was 30% and in the more than five decades since 1960, the S&P 500 had met or exceeded a 30% total return only six times prior to 2013: 1975, 1980, 1985, 1991, 1995 and 1997. While it was a remarkable year for all equities, low quality and small capitalization stocks did the best. According to Merrill Lynch, the lowest quality stocks (C&D ranked by S&P) led the way, rising 45% on the year vs. 25% for the highest quality (A^+ ranked)[*]. Similarly, the top 50 market capitalization stocks of S&P 500 underperformed the bottom 450 by 7% (26 vs 33%).

As we wrote to you in our last quarterly report, October 2013, one noteworthy side effect of 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 easy money is pockets of silly valuation in the market. Examples include the current biotech/health care mania (multi-billion dollar valuations for companies with a promising compound or gene therapy but little revenue), cloud software stocks, and Chinese internet stocks where little is really known other than an appealing sounding business proposition to go along with an ADR listing on a U.S. exchange. As noted in our 3rd quarter report, though certainly not yet a 2000 tech bubble or 2007 housing bubble, it is something to keep our eye on and a reminder to maintain investment discipline and perspective. The animal spirits have been rekindled and considerable fireworks should be in store for markets in the years to come.

[*]*The Standard and Poor Quality ranking system attempts to measure the growth and stability of earnings and dividends, and has been calculated on common stocks since 1956. It covers 3,500 companies.*

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 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 up 66% from 2008 recession low. Forecast to hit @ 16.5 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 2013
- Monthly inflows into equity mutual funds remained positive throughout 2013 for the first time in many years, with several months experiencing strong inflows.

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 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 27 months).
- Accommodative Fed, ECB & BOJ
- *Appointment of Janet Yellen as Fed Chairman insures continuity with Bernanke and current stimulative policy.* Despite Fed taper announcement, Fed policy remains highly accommodative:
  1) Fed balance sheet still expected to increase by \$400-\$500B in 2014 or 10%-12%.
  2) 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:
- We have likely reached a tipping point where investors re-allocate capital out of fixed income and into stocks.
- Bond Fund flows turned sharply negative in June as concerns grow over what happens as "bond bubble" and artificial low rate environment comes to an end; equity inflows, meanwhile, turned positive. Expect both trends to continue.
- 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. Thus far money moving out of bonds has gone roughly 60% into money market and 40% into equities.

Negatives

Global Growth Slowdown in 2013:
- 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:
- Concerns remain surrounding Fed's decision to "taper" their asset purchases, rising interest rates, and the overall impact of winding down of monetary stimulus program.
- Tapering remains data dependent, and growth and employment still below normal levels.

Tax & Regulatory Headwinds
- Federal Sequestration hurting growth, but fiscal drag on the economy lessened by recent congressional "Ryan-Murray" fiscal budget agreement.
- Higher tax rates and healthcare costs impact consumer spending.

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 continue to be a breeding ground for geopolitical crisis.