Strategy Quarterly

First Quarter 2013

CYPRESS TRUST COMPANY

Executive Summary

❑ Despite the market anxiety and uncertainty surrounding the 2012 U.S. presidential election, the fits and starts in the resolution of Europe's financial crisis, postulating about the fiscal cliff, etc., equity markets actually posted a very good year. Equities enjoyed a well above average year with the S&P 500 up 16%, as compared to its average return of 10% since 1970.

❑ The lesson we hope investors learned in 2012 is that a focus on asset allocation and securities selection rather than on macro or political events is key to growing and preserving wealth over the long-term.

❑ We remain cautiously optimistic on equity markets in 2013. Supporting a positive outlook are reasonable valuations, relatively attractive corporate fundamentals and healthy cash balances, coupled with slowly improving economic fundamentals such as housing and job growth.

❑ Downside risks to equities include the potential for corporate margins peaking, political friction in the U.S. or Europe, along with a potential slowdown of global economic growth.

❑ Declining money velocity makes inflation less of a near-term risk than many believe, in spite of the dramatic increase in the money supply.

❑ Fixed income should include sectors of the market with lower correlations to the "core" of the bond market. This includes emerging market and high yield debt among others to improve risk profiles of portfolios that invest exclusively in U.S. high-grade debt.

❑ Increased regulation has lowered liquidity in the bond market significantly. We are increasingly recommending that exchange-traded funds play a larger role in bond portfolios due to their liquidity advantage over individual bonds.

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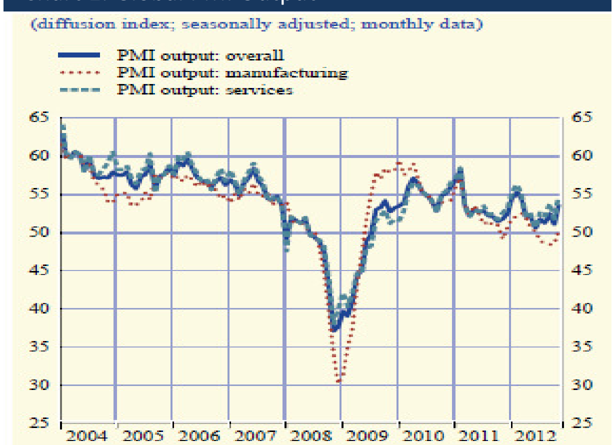
Global Economic Backdrop

The world economy continues to grow at a slow pace, with activity remaining muted. In the OECD area, quarterly real GDP growth increased by 0.2% in the third quarter of 2012, the same rate as in the previous quarter, but below the 0.4% increase recorded in the first three months of this year. As the year progressed, spillovers from the crisis in Europe weighed negatively on activity and confidence and the global recovery slowed. Labor market conditions, heightened uncertainty, and ongoing balance sheet repair will continue to restrain the pace of growth, particularly in a number of advanced economies. Meanwhile, GDP growth in emerging economies has decelerated, in part due to past policy tightening, but also due to higher uncertainty and lower confidence. The gradual global recovery is expected to continue, although with considerable dispersion in growth rates across countries. Economic activity in

Chart 1. Global PMI Output



Source: OECD

the emerging markets are expected to expand solidly as compared to advanced economies, thereby providing a larger contribution to global economic growth. The Global Purchasing Managers' Index (PMI) for output increased to 53.7 in December, from 53.6 in November (see Chart 1). The improvement in business conditions was driven by a higher reading in the manufacturing index and stabilization in the services sector. Manufacturing PMI climbed above the neutral 50 mark that divides expansion from contraction, following six months of readings that were below the threshold.

The more forward-looking PMI for overall new orders has shown some signs of stabilization, standing at 52.9 in December, although the rate of expansion remains modest and suggests subdued growth momentum in the near term.

Over the past year, world import growth has slowed much more sharply than overall activity. High uncertainty, particularly in Europe, and subdued confidence appear to have dampened demand for durable and investment goods, which has affected global trade flows. Short-term survey indicators continue to point towards a weak trade environment, with the global PMI for new manufacturing export orders now having remained below the expansion-contraction threshold for eight consecutive months (Chart 2).

Global inflation eased in November, as energy prices resumed their downward trend, following a temporary acceleration in the previous months. In the OECD area, annual headline consumer price inflation stood at 1.9% in November, following an increase of 2.2% in the year to October. Inflation declined in the United States owing to declining energy prices, while it increased in China, driven largely by rising food prices. Excluding food and energy, the annual rate of inflation in the OECD area remained unchanged for the fourth consecutive month at 1.6% in November.

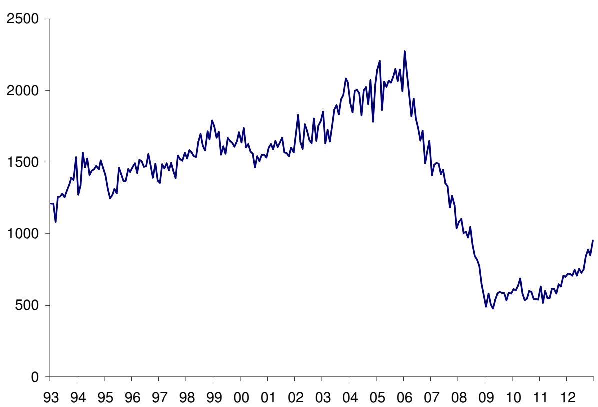
Chart 2. Global Trade Indicators (% Change)

Source: ECB

United States

In the United States, real GDP growth accelerated in the third quarter of 2012. According to the third estimate by the Bureau of Economic Analysis, real GDP increased at an annualized rate of 3.1% in the third quarter of 2012, up from 1.3% in the second quarter. In the third estimate, real GDP growth in the third quarter was revised upwards owing to stronger than previously estimated contributions from personal consumption expenditure and net exports. Compared with the second quarter, the increase in growth was led mainly by buoyant personal consumption expenditures and by an upturn in government spending and inventory investment. Economic activity in the third quarter also benefited from the acceleration in residential private investment and a positive contribution of net exports. On the other hand, non-residential private investment declined.

Chart 3. Housing Starts (thousand units)



Source: FactSet

Recent indicators suggest that economic activity expanded at a moderate pace in the fourth quarter of 2012. The labor market continued to show signs of improvement in December, as the number of non-farm payrolls increased further and the unemployment rate stabilized at 7.8%, the lowest level in four years. However, part of the recent decline in the unemployment rate was due to a decline in the participation rate. At the same time, further evidence of the gradual recovery in the housing market was reflected in continued increases in home prices as well as higher home sales.

The FOMC remains committed to promoting maximum employment and price stability; the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens. In particular, the Committee decided to keep the target range for the federal funds rate at 0% to 0.25% percent and currently anticipates that this exceptionally low range will be appropriate at least as long as the unemployment rate remains above 6.5%. Inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2% longer-run goal, and longer-term inflation expectations continue to be well anchored.

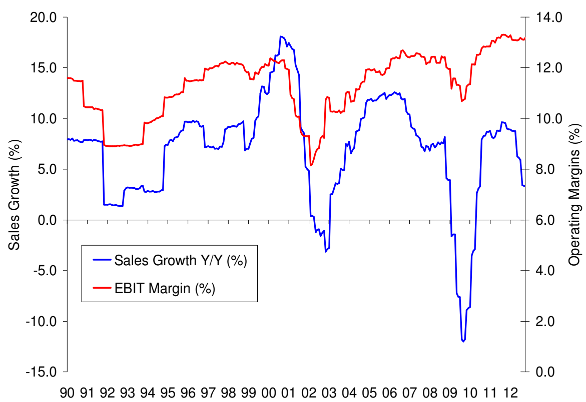
We believe that this unprecedented formal commitment of the Fed to remain accommodative until the unemployment rate falls below a specific threshold should support the economy and dampen downside risk to financial markets.

Looking ahead, the issue of tackling long-term fiscal imbalances was left unaddressed by the recent political agreement on tax and spending reforms, leaving the near-term outlook surrounded by considerable uncertainty, with the economy expected to stay on a rather moderate growth path in the coming quarters. However, most recent U.S. economic data seem relatively encouraging with positive trends in industrial production, housing starts, mortgage applications and retail sales. These trends may suggest that we are more likely to enter a “mid-cycle slowdown” rather than a full recession.

With the “Fiscal Cliff” saga waning – at least for the moment - macro and policy worries in the market are giving way to a focus on the bottom-up data such as corporate earnings and margins.

Yet, cyclical headwinds remain. With corporate and profit margins at all-time highs, revenue growth is needed to support current earnings growth expectations. The next section delves into the micro drivers of equity prices.

Chart 4. Sales Growth and Corporate Margins

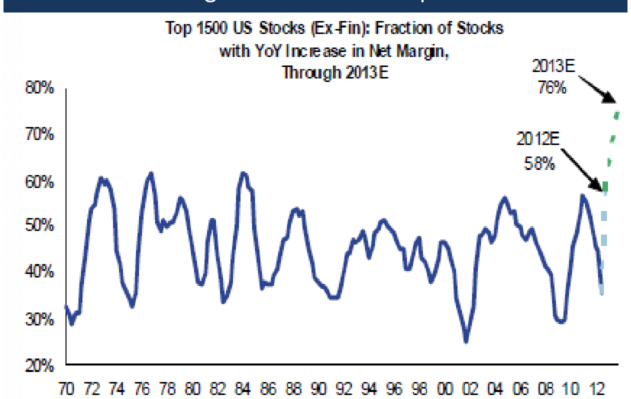


Source: FactSet

For the last couple of quarters, we have been concerned by peaking corporate margins and a slowdown in revenue growth. With EBIT margins now at historically high levels (red line in Chart 4) and with sales growth slowing considerably (blue line) it's difficult to see how U.S. companies will sustain current profitability and growth rates over the next few quarters.

Chart 5 graphs the percentage of companies reporting an annual increase in net profit margins for the 1970-2012 period. Also reported are the values for 2013 based on street analysts' projections. We believe expectations are too optimistic and may set investors up for disappointment.

Chart 5. Net Margins – S&P 500 Companies

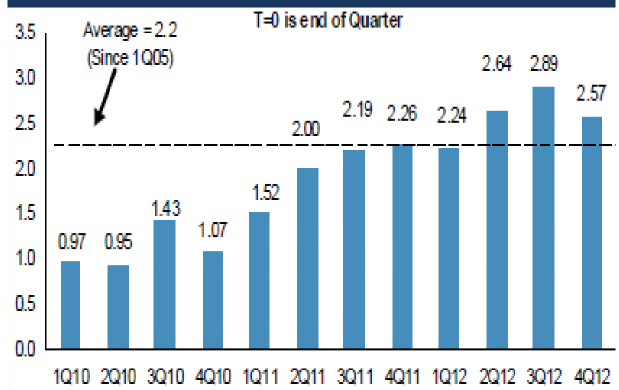


Source: Morgan Stanley

As we have expressed in the past, cyclical headwinds persist and will continue to create resistance to any market advance despite the most accommodative monetary policy of the last few decades.

Negative signals have also been shared by management as their assessment of their companies' prospects have worsened as captured by an increasing ratio of negative-to-positive earnings guidance (Chart 6).

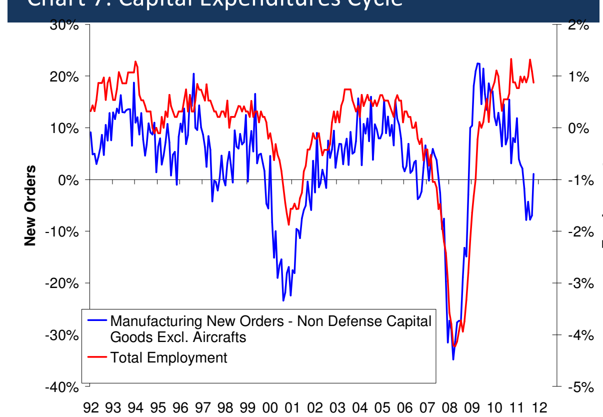
Chart 6. Ratio of Negative to Positive Guidance



Source: Morgan Stanley

What could help revenue and corporate profits - or at least partly offset the aforementioned headwinds - is a potential surge in capital expenditures as a result of pent-up demand built up during this cycle as corporations put off investments due to economic and political uncertainty. The chart below shows the apparently unsustainable divergent trends of capital expenditures and employment. Manufacturers' new orders – a proxy for capital expenditures – have tracked quite closely changes in the employment rate over time.

Chart 7. Capital Expenditures Cycle

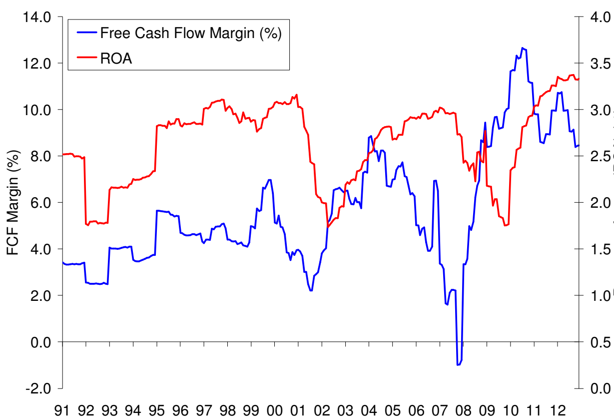


Source: FactSet, Census Bureau, Bureau of Labor Statistics

More recently a divergent pattern has emerged suggesting that a potential rapid increase in capex is needed to re-establish the equilibrium.

We note that corporate earnings are currently supported by both high profitability and good quality (as proxied by return on assets and free cash flow margin, respectively). Efficient capital allocation and cash flow generation tend to be good predictors of future earnings growth.

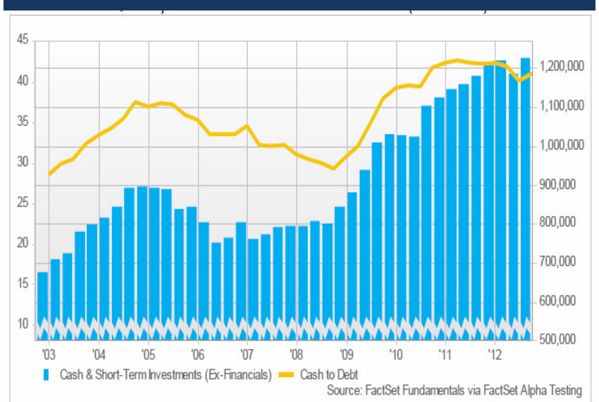
Chart 8. Free Cash Flow Margin and ROA



Source: FactSet

Cash on balance sheets remains very high at about $1.2 trillion. Cash as a percentage of debt sits at an all-time high of about 42%.

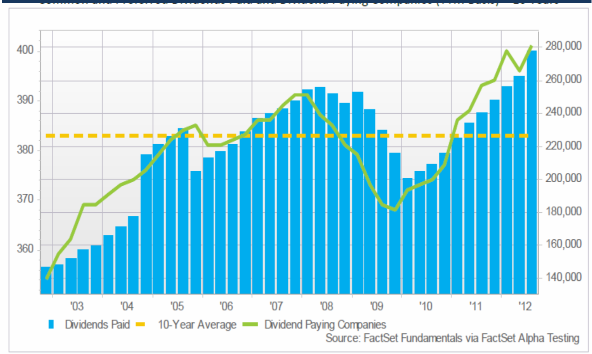
Chart 9. Cash and Short-Term Investments



Source: FactSet

As we have expressed in the past, we believe that this positive combination of strong cash flow generation and a very favorable net cash position should continue to support dividends and share buybacks and therefore act as a buffer for the stock market. Indeed, this robust free cash flow generation has translated into strong dividend growth and higher payouts. As of October 2012, for the trailing twelve months, aggregate dividend payments for the S&P 500 totaled $277.4 billion.

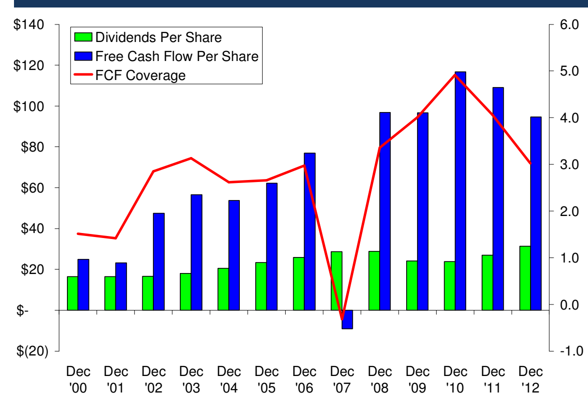
Chart 10. Dividends



Source: FactSet

On a per-share basis, the aggregate dividend payment was $29.9 per share, reflecting year-over-year growth of 15.5%. The current S&P 500 aggregate payout ratio amounts to about 30%. This is still well below the 30-year median of 40%. Chart 11 plots dividend per share and free cash flow per share over the last decade. Abundant cash flow generation results in ample "dividend coverage" thus signaling potential for future dividend growth.

Chart 11. Dividends and FCF per Share – S&P 500



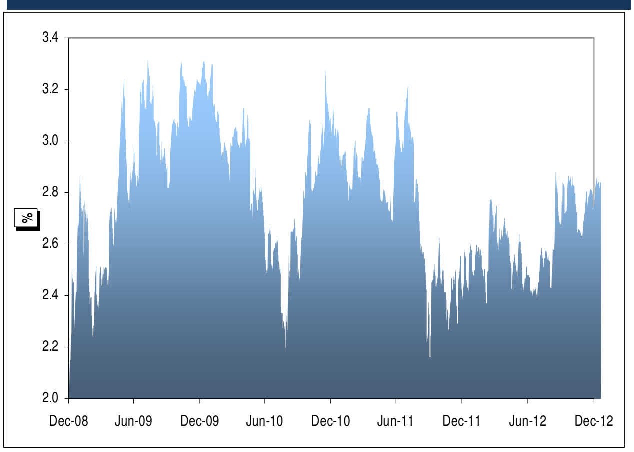
Source: FactSet

The preceding analysis depicts a quite healthy picture of U.S. corporations, which display strong cash flow generation, low debt ratios, and massive cash balances. This "bottom-up" strength of U.S. equities cannot be ignored, particularly in periods of macro turbulence such as the current one. While macro events and their consequences are almost impossible to forecast, companies' financials can be monitored and evaluated in a quite systematic fashion and are more directly linked to future equity returns, in our view.

Credit Markets: Inflation & The Bond Market

We take a break from discussing Europe in this quarterly piece to tackle another oft-debated topic, that of inflation. There are some who believe inflation will be a serious issue in the coming years, with those on the fringes believing in hyperinflation and others believing that deflation, not inflation, is the real risk. Let us take a look at a forward predictor of inflation rates and a gauge used by the Federal Reserve, the *5-Year, 5-Year Forward Breakeven Inflation Rate*. Since monetary stimulus began, this measure has tended to be correlated with monetary policy actions (rounds of quantitative easing). Although it has increased 0.40% since the summer and is now slightly higher than 2.75% this indicator is far from signaling high inflation.

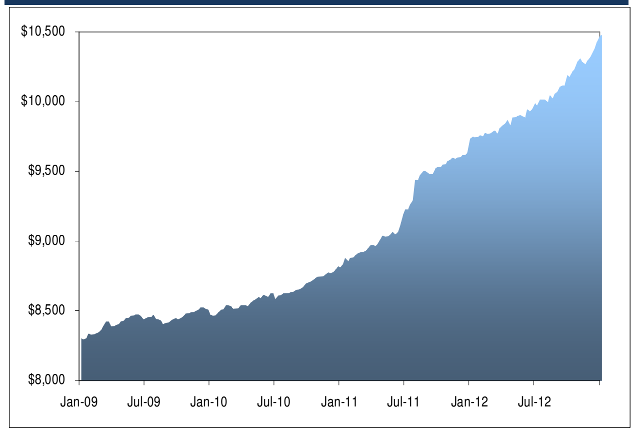
Chart 12. 5-Yr., 5- Yr. Forward B/E Inflation Rate



Source: Bloomberg

The pro-inflation argument is based on the massive expansion of the money supply. There is certainly merit to this argument as inflation is defined as "too many dollars chasing too few goods." One quick glance at the following chart and it is clear the expansion of the money supply has been unprecedented. However, inflation is also a function of demand and to have demand, economic growth is needed, as is wage growth. Real wage growth has been anemic; although economic growth has picked up, it is still tepid. We need to look closer at the link between economic growth and inflation.

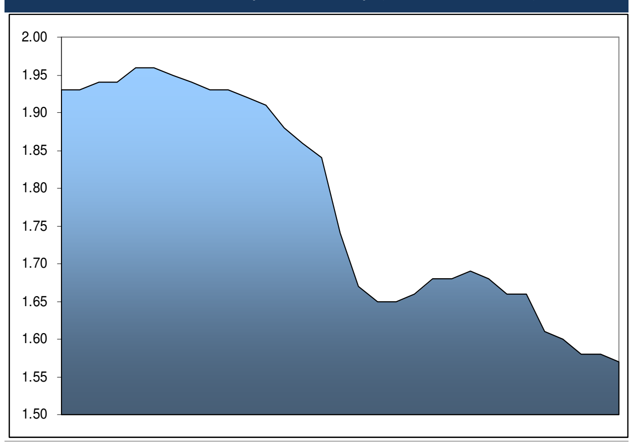
Chart 13. Money Supply (M2)



Source: Bloomberg

One important measure of economic activity that ties into inflation is the velocity of money (Nominal GDP/ Money Supply), which measures the frequency with which a unit of money is spent on new goods and services. For the inflation rate to rise, the velocity of money has to rise as spending increases. The velocity of money is still very low.

Chart 14. The Velocity of Money (2005-Present)

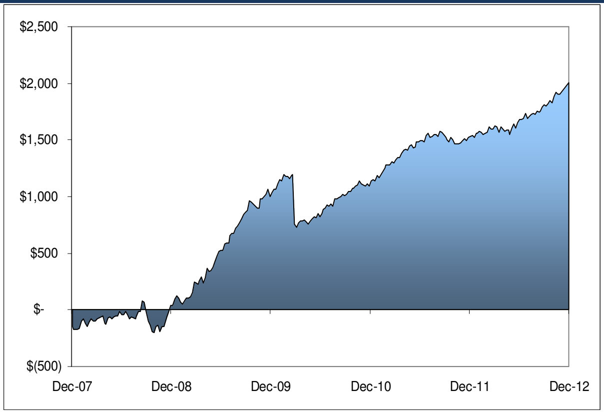


Source: Bloomberg

To illustrate, say a large global bank sells Treasury bonds back to the Federal Reserve (for example, through a "quantitative easing" program where the Fed buys Treasury debt) and receives dollars. If those dollars are recycled into the economy through loans or investments, they create economic growth and increase the velocity of money.

Alternatively, if those dollars sit in a bank vault they create no economic growth, which reduces the velocity of money. This is in fact what is happening. Cash is sitting idle in bank vaults as bank liquidity has increased substantially. Deposits now exceed loans by $2 trillion while cash held by U.S. banks has expanded 8.7% this year to a record $9.2 trillion. This is not inflationary.

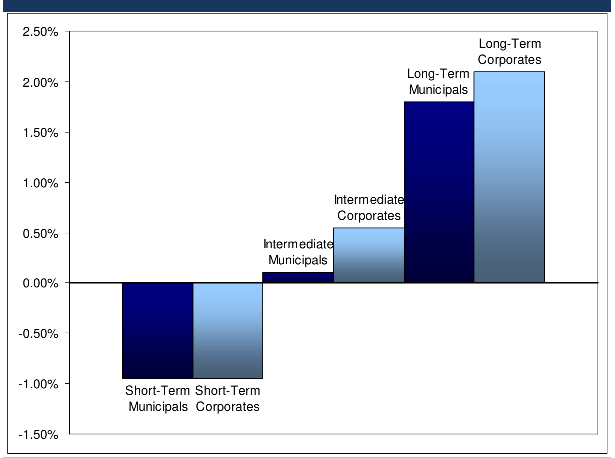
Chart 15. U.S. Bank Surplus Liquidity (Deposits less Loans) (in billions)



Source: Bloomberg

However, inflation should not be discounted entirely when making investment decisions, particularly in the context of fixed income. While inflation is relatively low, so are yields. In fact, real yields or yields after inflation are often negative in today's environment. In many circumstances, bond investors are not being compensated for inflation.

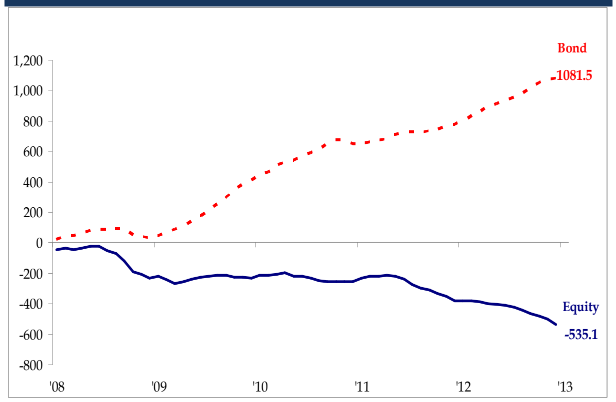
Chart 16. Real Yields in the Bond Market



Source: Cypress Trust Company

This makes the flood of money into fixed income all the more puzzling. What explains this phenomenon? To a degree it is a function of investors following past performance as well as demand for the perceived safety of the bond market versus the equity market. The more important question is, what will reverse this trend?

Chart 17. Fund Flows-Equity vs. Fixed Income (2008-October 2012)



Source: Strategas

Credit Outlook

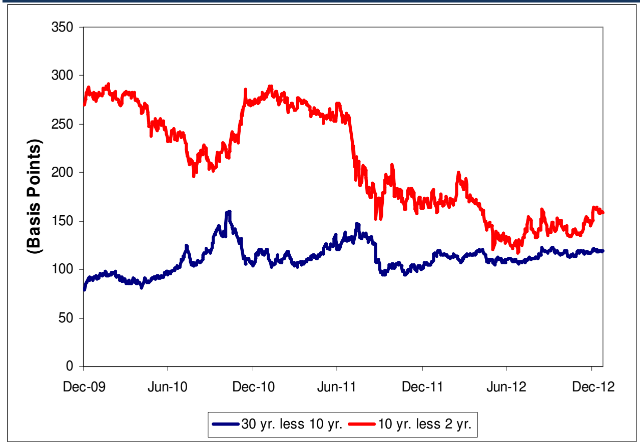
The answer to the previous question may be as simple as investors seeing losses from their bond investments on their monthly account statements. Presently, the average investor is not concerned with the overvaluation in the bond market, nor with the negative real yield argument. Total return (price appreciation + coupon income) on fixed income investments has continued to be strong, with low double-digit/high single-digit returns for investment grade and municipal debt in 2012. This, however, is not an argument for continued outperformance. We would reiterate that return expectations should be lowered going forward.

To mitigate this risk, we are increasingly advocating a broader approach to fixed income, which includes exposure to fixed income sectors with lower correlations to the "core" bond market (i.e., Treasuries and investment grade debt). For example, we believe in adding modest allocations to high yield debt and emerging market debt, where appropriate. Both sectors have lower correlations to the "core" bond market, and historically high yield has a negative correlation with the overall bond market. Additionally, while we recognize that inflation is not an immediate concern as previously outlined, it should not be completely ignored as inflation is deadly to bonds. Again, where appropriate, we have begun recommending an allocation to inflation-protected securities.

Last quarter we wrote that monetary policy is being asked to cover up the absence of lucid fiscal policy coming out of Washington. It seems you cannot turn on the television, open a newspaper or get on the web without hearing everybody's opinion on the "fiscal cliff" and now the debt ceiling. We will spare you one more commentary, as predicting the ultimate outcome of political negotiations is not our area of expertise.

However, what is the bond market saying about the economic impact of the fiscal negotiations coming out of Washington? First of all, a little context is needed. History has unequivocally proven that the single most effective predictor of a recession or economic downturn is the yield curve, specifically the slope of the yield curve. Forget all the pundits on television opining about the economy and look to the yield curve. If it is inverted a recession is imminent. If it is falling, then economic growth will be slowing; rising and economic growth is set to rise. As shown in chart 18, the slope of the yield curve as measured by the difference between the 10 year bond and the 2 year bond (in red) has been trending upward. If we use the difference between the 30 year and 10 year bond (given that the Fed is controlling short-term rates), the slope (in blue) is also trending upwards. Neither yield curve is implying robust growth, but neither are they implying slowing growth or a coming recession resulting from the political squabbling coming out of Washington.

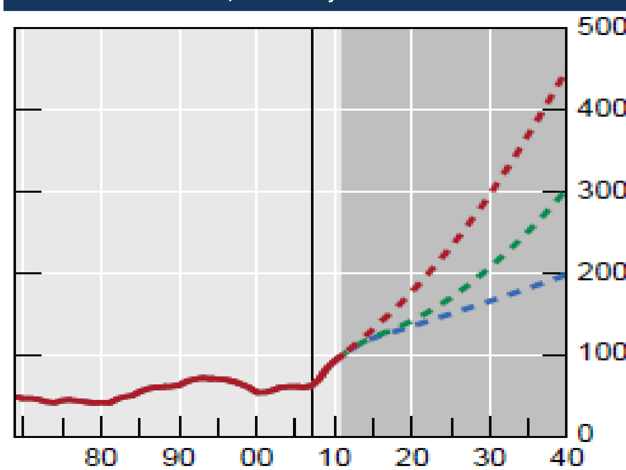
Chart 18. Yield Curve Slopes



Source: Bloomberg

The "fiscal cliff" discussion goes much deeper to the bigger issue of government indebtedness. The following chart shows three different debt-to-GDP paths for the United States under various fiscal adjustments. The debt/GDP path under each of the three spending scenarios is worrisome. When a nation reaches a debt/GDP ratio that exceeds 100% it becomes very difficult to reverse as debt increasingly drags on economic growth. Fiscal discipline should go deeper than addressing a few expiring tax cuts and should address the challenge of unsustainable entitlement programs. Without doing so, debt levels will remain persistently high and continue to be an anchor on economic growth. This is a bigger topic that we will continue to examine.

Chart 19. U.S. Debt/GDP Projections



Source: OECD, Bank for International Settlements

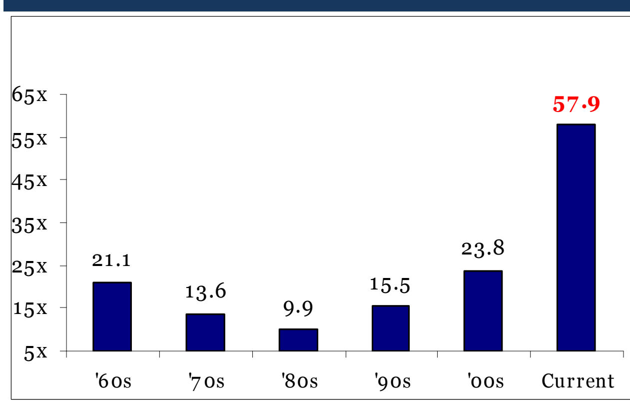
In spite of all the noise in the market, fixed income should continue to play a role in proper asset allocation. However, investors should not ignore sector allocation within fixed income. This theme of broadening fixed income sector exposure to mitigate risk will be explored further in upcoming quarterly pieces. Regardless, we maintain our cautious view on the bond market.

Interest Rate Outlook

At the FOMC meeting on December 12th, the Federal Reserve Board of Governors set targets for inflation (2.5%) and unemployment (6.5%) that would be cause for a change in the current monetary policy stance of near-zero interest rates. With inflation running at 1.6% and the unemployment rate at 7.8%, the FOMC essentially reiterated its previous statement that "exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015" - but did so by quantifying, for the first time since the credit crisis began, target inflation and unemployment rates.

With the Fed focused on keeping rates low through unprecedented monetary actions the question has to be asked, what is a "fair value" for the Treasury? One unique approach is to look at a bond like a stock, assigning the bond a P/E (price-to-earnings) ratio with coupon income serving as earnings. The current 10-year Treasury yield results in a bond "P/E" that dwarfs the previous high multiples. For example, a 5% yield on the 10-year would be a 20x multiple, still high by historical standards. The current yield on the 10-year is 1.97% .

Chart 20. Average 10-Yr. Treasury Bond "P/E" by Decade



Source: Strategas

Fed policy has pinned down the short end of the yield curve and is determined to keep a ceiling on rates. That is not to say that rates will remain static. While we cannot point to an imminent catalyst to move rates higher, that does not mean it will not happen. In general, the risk in the debt markets resides with interest rate risk, not credit risk. Investors should try to avoid negative real yields by taking on moderate interest rate risk, as yields inside of 5 years are simply non-existent.

Implications for Bond Portfolio Management

Government/Agencies

Valuations on government securities are stretched to say the least (see bond "P/E" chart) and financial repression, which we expect to be persistent for the foreseeable future, has resulted in negative real yields on much of the government debt outstanding. Rising levels of government indebtedness and low absolute yields make this an unattractive sector of the fixed income market. However, Treasuries should not be entirely ignored as they provide additional safety, but should be part of a broader fixed income sector allocation.

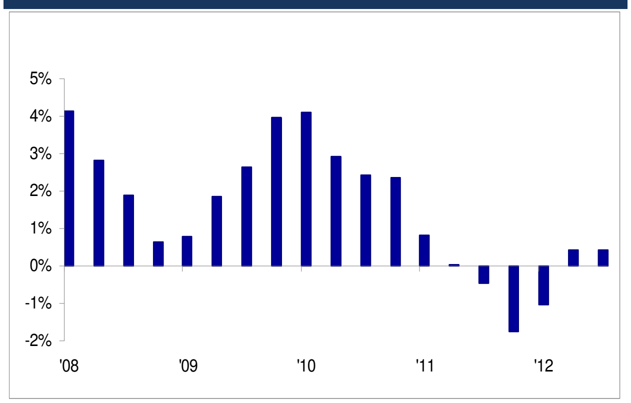
Municipals

It is now a distinct possibility that the municipal bond tax exemption will be altered in some manner by policymakers. The ultimate outcome is unknown, but a 28% cap on the tax exemption applied to certain income brackets is gaining more and more traction. Also gaining more steam is applying any change in the tax exemption retroactively to all municipals. This would be a negative for the municipal market which would likely see a sell-off and a rise in yields as the tax exemption is what makes municipals attractive to its individual investor base. Regardless of the final outcome it is likely that the municipal bond market will experience heightened volatility as the market responds to rumors coming out of Washington regarding the tax exemption. This "tax risk" led to a late 2012 sell-off, but the market largely rebounded and continues to be characterized by strong demand and moderately light supply, which has resulted in solid returns.

We continue to have a preference for essential service revenue bonds, "kicker" bonds (callable, high-coupon, premium bonds) and for issues from states in the Southeast, mid-Atlantic, Great Plains, and Rocky Mountain regions, as well as select Western and Midwest states.

A quick note on debt from the state of Florida. Although we do not have a bias for Florida municipal debt as a Florida-based investment manager, it is worth noting that the performance of Florida municipal debt (state and municipalities) has been the best in a decade with returns in the high single-digits for 2012. The primary driver of this performance has been an improving credit profile due to falling debt levels, spending cuts, and fiscal reform in Tallahassee. The bigger takeaway is that the majority of states and municipalities are doing what the federal government is not - being fiscally responsible by reducing debt and cutting expenses.

Chart 21. State & Local Gov't Debt (YoY, % Change)

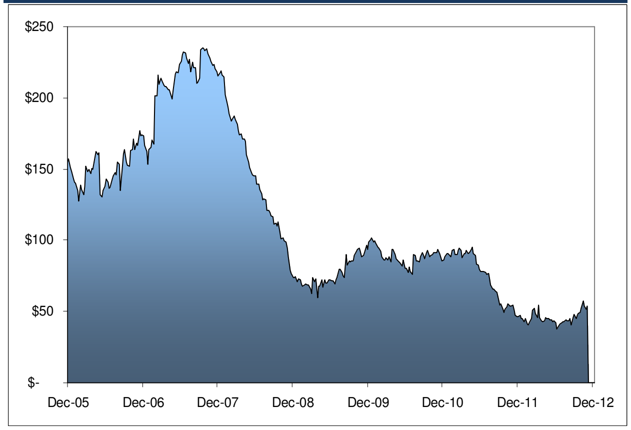


Source: Federal Reserve, Flow of Funds, Strategas

Corporate Debt

One of the dominant trends impacting the corporate bond market is the drop in liquidity that has occurred over the past several years. This has been a multi-year process driven largely by increased regulations including, 1) higher capital ratios which require deleveraging of bank balance sheets, 2) the closing of bank proprietary trading desks due to Dodd-Frank, 3) Dodd-Frank regulations limiting certain trading activity, risk taking and asset classification, and 4) the buyers of high-grade corporate debt are increasingly putting these bonds away and not trading them in the secondary market.

Chart 22. Primary Dealer Positions



Source: Bloomberg

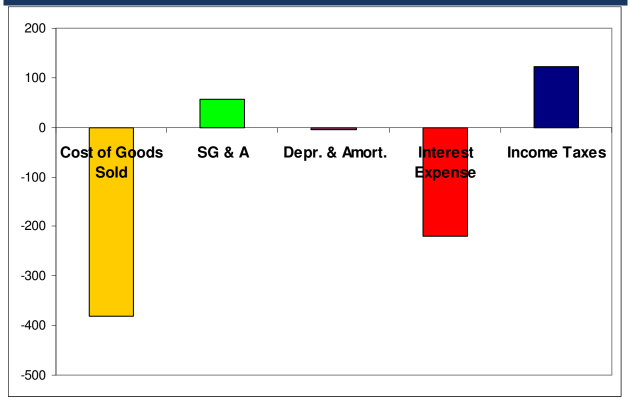
As noted in the above chart, which measures the amount of corporate bonds held in inventory by the 21 primary dealers authorized to trade with the Federal Reserve, dealer positions have been cut from $235B in October 2007 to $54B at the end of November 2012.

The drop in liquidity has important implications for bond portfolio management. Firstly, lower liquidity increases liquidity premiums, with higher yields available on less liquid bonds that investors can take advantage of if they have a buy and hold approach and liquidity is less of a concern. However, this tends to be the minority of investors. Secondly, volatility rises as liquidity drops. This could become particularly worrisome should there be a run for the exits by the retail investor who has stampeded into fixed income over the past several years. The lower liquidity would only make an orderly exit all the more challenging. As such, we are increasingly advocating the use of exchange traded funds (ETFs) which offer much better liquidity than individual issues to gain exposure to the bond market.

Within the investment grade bond market, catalysts for further spread tightening are difficult to find. Deleveraging and refinancing at much lower rates have improved credit profiles substantially within the investment grade credit space, thus improving profit margins as well. Historically, profit margins are negatively correlated with credit spreads.

Higher margins result in higher profitability and lower risk premiums (credit spreads) on bonds, which lead to strong returns and vice versa. Since corporate deleveraging began in 2008, corporations have taken costs out of their income statements through cost of goods sold and lower interest expense due to refinancing at lower rates and paying off debt obligations (see chart 23).

Chart 23. Change in Key Income Statement Items as a % of Sales Since 2008 (in basis points)



Source: Strategas

We remain skeptical as to how additional cost reductions can be realized as the bulk of debt refinancing has been completed and rates cannot move materially lower. This removes a tailwind to profit margin improvement. Additionally, we are increasingly seeing corporations implement shareholder friendly uses of cash, such as share buybacks and dividends. Shareholder friendly capital allocation comes at the expense of bondholders, as not only is cash going more to shareholders over bondholders, but corporations are borrowing to fund buybacks and dividends (i.e., Lowe's, Amgen). Credit profiles are still strong across corporate America, but further improvement is unlikely. This shift in value creation within the corporate bond market is a reason for caution.

Portfolio Positioning

2012 was a year dominated by two main fiscal crises – one in Europe and one in the U.S. As the fiscal cliff debate subsides and political uncertainty dissipates, the focus will shift on the monetary policy and the sustainability of the nascent global economic recovery. The removal of political uncertainty should free pent-up demand in both the business and consumer sectors. Other positive factors are low borrowing costs and an improving housing market. A highly accommodative monetary policy from global central banks should also reduce stock volatility and correlation across stocks and among asset classes. Such an environment should favor risky assets as liquidity trumps weak fundamentals.

We always advise investors to emphasize long-term strategic asset allocation. A truly diversified portfolio comprised of uncorrelated asset classes and optimized to reflect the investor's risk profile is the best approach to withstand market and economic turbulence, in our view.

Within fixed income, valuations remain rich but fixed income should remain a part of proper asset allocation. Investors should consider broadening their sector allocation within fixed income to include sectors such as mortgage debt, high yield, inflation protected debt, and emerging market debt which offer risk management benefits. Liquidity has dried up in the bond market, making the addition of more liquid securities such as fixed income ETFs a prudent decision. We reiterate that going into 2013, return expectations should be lowered as catalysts for further upside potential (rates and spreads) are limited. Furthermore, the municipal market may start off the year with uncharacteristic volatility as policymakers look increasingly likely to reduce the tax exemption of municipal bonds.

In pure equity portfolios, we believe that improving political stability, global liquidity and global economic recovery could favor riskier segments of the equity markets such as value and small capitalization stocks.

Portfolio Management Massimo Santicchia is the Chief Investment Officer for Cypress Capital Group, Cypress Trust Company and Crest Investment Partners. He directs all aspects of the investment strategy as well as develops and manages his own custom equity portfolios. Santicchia has 16 years of investment experience including: S&P Investment Advisory Services LLC, as portfolio manager of JNL/S&P 4 funds and co-managed JNL/S&P Managed and Disciplined funds.

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