

Strategy Quarterly

Third Quarter 2013



Executive Summary

❑ The June FED's announcement of a timetable for ending QE sparked a sharp sell-off of both bonds and equities. We have warned in the past that fixed income securities would be vulnerable to a reduced FED support and higher interest rates.

❑ The FED's decision to taper its bond purchases due to expectations of stronger real growth rather than higher inflation, should be ultimately favorable to equities, we believe.

❑ In fact, we see the exit strategy laid out by Mr. Bernanke as carrying a number of positive factors, such as reduced uncertainty and interest rate normalization. With the housing market recovering, consumer confidence improving, and fiscal pressure diminishing, the need for further stimulus is lessening.

❑ The June upward shift in the yield curve is a reminder of the primary risk facing bond investors: rising rates. Do not panic in spite of recent losses in the bond market. We recommend opportunistically adding to allocations on market sell-offs.

❑ Portfolios should be strategically structured for the potential of rising rates. From an asset allocation standpoint, low rates, inflation, and an improving economy pose challenges to fixed income. We recommend complementing core bond allocations with an inflation hedge and income producing assets to enhance diversification across sectors.

❑ Take prudent credit risks over interest rate risk. Some of the riskier portions within credit have sold off and now offer more attractive valuations.

❑ We are overall positive on equities on still very accommodative monetary policy, reasonable valuations and healthy balance sheets. As we enter the expansion phase, cyclical growth stocks, driven by earnings momentum, should take the lead away from value stocks.



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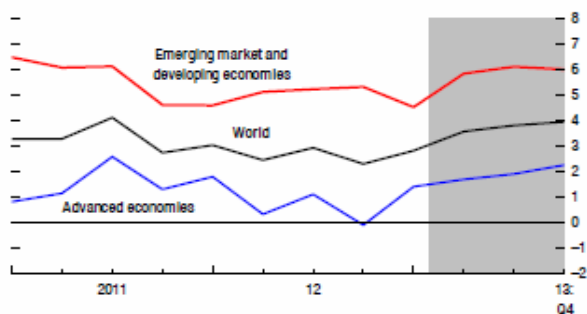
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Global Economic Backdrop

According to the International Monetary Fund (IMF), global growth is projected to remain subdued at about 3 percent in 2013, the same as in 2012. Appreciably weaker domestic demand and slower growth in several emerging market economies, as well as a more protracted recession in the euro area, are headwinds to growth. Downside risks to global growth prospects include the possibility of a longer growth slowdown in emerging market economies, especially given risks of lower potential growth, slowing credit, and possibly tighter financial conditions if the anticipated unwinding of monetary policy stimulus in the United States leads to sustained capital flow reversals. According to the IMF, stronger global growth will require additional policy action: major advanced economies should maintain a supportive macro economic policy mix, credible plans for reaching debt sustainability, and reforms to restore balance sheets and credit channels.

Chart 1. Global GDP Growth (% Q/Q Annualized)

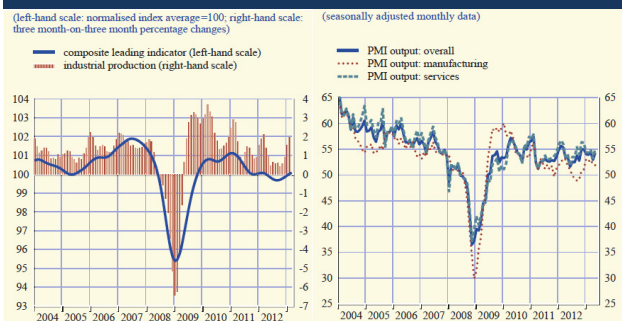


Source: IMF estimates

According to the European Central Bank (ECB), global financial market conditions have improved and business sentiment remains supportive of modest growth. Looking forward, survey indicators appear to have stabilized, suggesting that the world economy will continue to grow, albeit at a slow pace. The latest global all-industry output Purchasing Managers' Index (PMI) picked up in May to 54.3 following a decline in April. The improvement was driven entirely by a more positive assessment of the services sector, while the manufacturing index deteriorated slightly, but still remained above the expansion/contraction threshold (see Chart 2).

On the consumer side, surveys suggest that confidence continues to improve to varying degrees across countries, albeit from low levels. According to the CPB Netherlands Bureau for Economic Policy Analysis, world trade in goods quarterly growth was 0.7%, the same pace of growth as that recorded in the previous quarter. Trade dynamics improved in advanced economies, while exports and imports decelerated in emerging economies. This is in sharp contrast to recent quarters, when emerging economies were the principal drivers of growth in world trade. EM growth slowed to 4.0% y/y in the first quarter of the year, down from 4.8% in the final quarter of 2012. This compares with average EM growth over the past decade of 6.4%. Recent data suggest that the emerging world as a whole is now growing at its slowest pace since the global financial crisis. Although Emerging Asia remains the fastest growing region, growth there has now slowed for four consecutive months.

Chart 2. Composite Leading Indicator and Global PMI



Source: ECB and OECD

The ongoing downturn in China accounts for some of the slowdown but even South East Asia, which had been one of the region's bright spots, has started to slow. In Latin America, growth seems to have weakened further. Overall, it seems that the next year is likely to prove difficult for most EMs, and that a strong and sustained recovery remains some ways away. According to Capital Economics, the slowdown in the biggest EMs is largely the result of structural factors and these economies are likely to continue to disappoint. Meanwhile, the smaller, more trade-dependent economies look set to remain weak until there is a meaningful recovery in global demand.

U.S. Focus

At the June FOMC meeting, FED Chairman Ben Bernanke delineated a plan to phase out its current quantitative easing program. The decision of “tapering” (i.e., reducing the purchases of bonds in order to keep interest rates low) is justified by improving economic fundamentals. In fact, as the FED noted, market conditions have shown further improvement in recent months despite still high unemployment and growth-restraining fiscal policy. Household spending and business fixed investment advanced, and the housing sector has strengthened further.

In addition, Mr. Bernanke stated that, “If the incoming data are broadly consistent with forecasts, the FED would moderate QE later this year; and if subsequent data remain broadly aligned with the FED’s current expectations for the economy, they would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear. In this scenario, when asset purchases ultimately come to an end, the unemployment rate would likely be in the vicinity of 7% with solid economic growth supporting further job gains.”

Despite the measured and conditional tone of the statement, the market reaction to such a plan was a sharp sell-off of both bonds and stocks.

This was an over-reaction to what we actually believe is good news – particularly for equity investors.

In effect, nearly four years of aggressive monetary policy from the U.S. and other leading central banks has resulted in the most accommodative monetary policy in history. And with the housing market recovering, consumer confidence improving and fiscal pressure diminishing, the need for further stimulus is lessening. Moreover, the risks of disruption to financial markets from the FED’s exiting QE increase with the length and magnitude of the QE program. An eventual FED decision to shrink its balance sheet by selling bonds could push long-term rates up and disrupt the markets and the economy. Inversely, choosing to postpone such a decision would potentially result in higher inflation.

In conclusion, despite the initial negative market reaction, we see the FED’s plan to exit QE as a positive for equity investors as it is driven by, and conditional to, improving economic fundamentals.

Indeed, increasing rates are generally associated with improving corporate and economic fundamentals and are typical of recovery and expansion phases of the business cycles. During these phases equities tend to perform well and, within equities, cyclical stocks have historically outperformed defensive issues (see Chart 3).

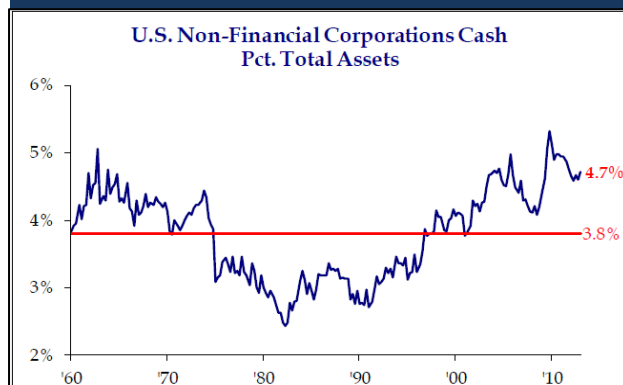
Chart 3. Interest Rate and Sector Performance

| Sector Performance During Periods of Rising Interest Rates (Annualized) | | | | | | |
|---|---------------------|---------------------|--------------------|--------------------|----------------------|---------|
| Sector | 9/30/93 to 11/30/94 | 12/31/95 to 8/31/96 | 9/30/98 to 1/31/00 | 5/31/03 to 6/30/06 | 12/31/08 to 12/31/09 | Average |
| Technology | 19.4% | 20.8% | 83.5% | 6.1% | 59.9% | 37.9% |
| Discretionary | -2.9% | 10.9% | 33.3% | 7.5% | 38.8% | 17.5% |
| Materials | 8.2% | 9.3% | 8.4% | 15.5% | 45.2% | 17.3% |
| S&P 500 | -1.0% | 8.9% | 26.7% | 9.4% | 23.5% | 13.5% |
| Industrials | -3.5% | 13.8% | 20.6% | 13.9% | 17.3% | 12.4% |
| Energy | -4.4% | 9.2% | 10.7% | 27.9% | 11.3% | 10.9% |
| Health Care | 16.9% | 8.5% | 5.2% | 2.3% | 17.1% | 10.0% |
| Financials | -12.4% | 14.7% | 14.9% | 9.3% | 14.8% | 8.3% |
| Staples | 11.5% | 13.4% | -4.1% | 6.4% | 11.2% | 7.7% |
| Telecom | -13.4% | -19.6% | 31.7% | 7.0% | 2.6% | 1.7% |
| Utilities | -20.3% | -7.4% | -1.5% | 13.3% | 6.8% | -1.8% |

Source: Strategas

Another notable positive corporate attribute is represented by the strong balance sheets of U.S. companies for which, on aggregate, the cash-to-total assets ratio was recently just below the historical high of 5%. These high levels of cash, together with relatively low payout ratios, bode well for future sustained dividend growth (see Chart 4).

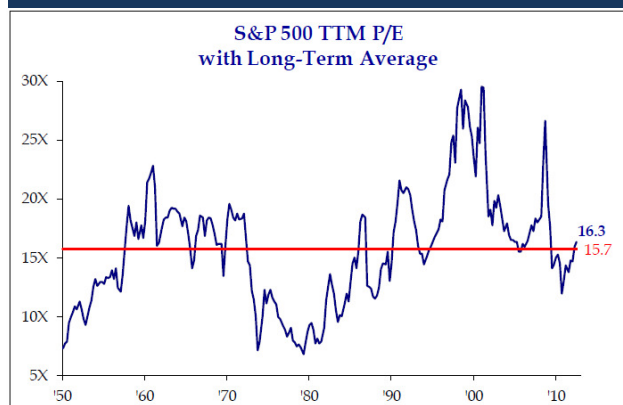
Chart 4. Corporate Cash



Source: Strategas, Federal Reserve

From a valuation standpoint, the equity markets do not appear overvalued, as the trailing price-to-earnings ratio is about in line with the historical long-term average, as displayed in Chart 5.

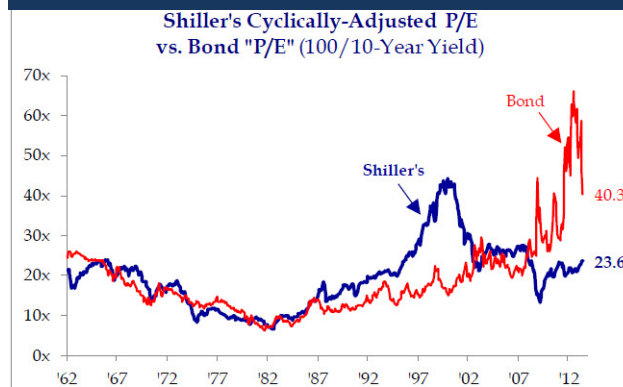
Chart 5. P/E Ratio – S&P 500



Source: Strategas

Despite the recent fall in bond prices, equities seem to still offer significant value relative to bonds as the long-term chart below indicates (Chart 6).

Chart 6. Valuation of Stocks vs. Bonds



Source: Strategas

The recent spike in bond yields has also pushed up mortgage rates (Chart 7), which tend to track yields on 10-year Treasury notes. These higher rates result in higher monthly mortgage payments and therefore could potentially kill the recovery of the housing market. We believe that while higher mortgage rates may dampen some housing market activity, the overall effect should be muted by the high level of affordability. In addition, pent-up demand for houses, after several years of depressed construction and a limited number of homes for sale, should support the housing market.

Chart 7. 30-Year Mortgage Rate

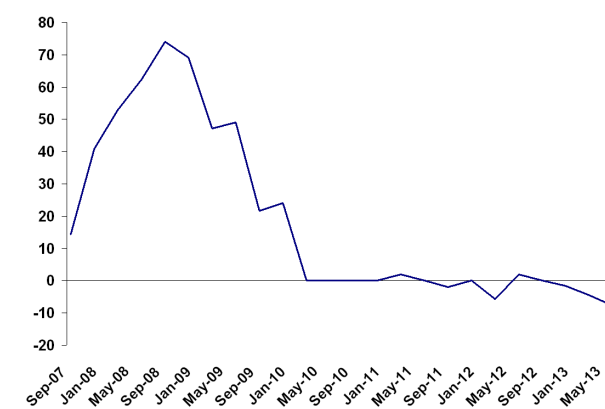


Source: Federal Reserve Bank of St. Louis

The key factor will be the availability of credit, which diminished significantly after the banks tightened lending standards in the aftermath of the 2008 financial crisis.

Chart 8 shows that credit availability has been actually improving quite consistently over the past three years after the 2008 credit crunch.

Chart 8. Net % Tightening Standards for Mortgages



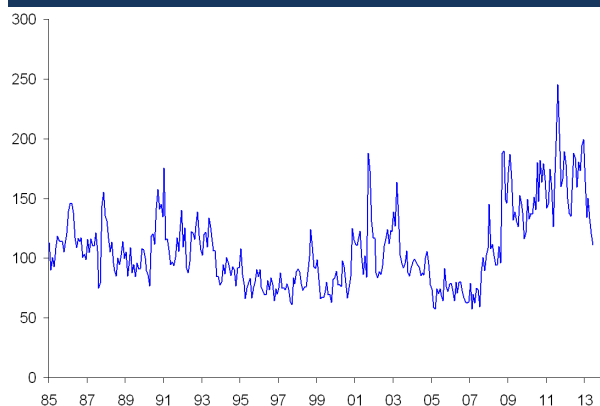
Source: Federal Reserve Bank of St. Louis

In conclusion, we believe that QE tapering will be much less damaging to the economy than people think. In fact, monetary policy remains accommodative with the money supply growing faster than the rate of inflation. And even with mortgage rates up to 4%, housing is still affordable with home prices rising by over 10% in the last year. Inflation is not a threat; the CPI has fallen from 4% in 2011 to only 1.1% recently, resulting in higher real purchasing power. The surge in consumer confidence in June indicates that households are likely to boost their spending.

Risks

In 2012 and through much of 2013, four key global macro risks have dominated the financial markets: 1) U.S. fiscal policy, 2) euro-area uncertainty, 3) oil price volatility, and 4) a China hard landing.

Chart 9. Economic Policy Uncertainty Index



Source: <http://www.policyuncertainty.com/>

According to academic studies, policy uncertainty leads to forecasts of decreasing economic growth and employment in the future. Chart 9 shows that political uncertainty has somewhat moderated over the last couple of years after the 2008 spike. However, the indicator shows that tax, government spending, and health care policy uncertainty are the main drivers of uncertainty since 2008, while monetary policy uncertainty has little effect, presumably because of stable inflation and low interest rates. Although the recent events in Egypt would drive the index higher, it seems that such events are having limited impact on the markets. Egypt is the largest oil producer on the African continent which is not a member of OPEC. A shut-in of the country's oil production would need to be replaced by increasing production from other oil suppliers and cut down on OPEC's spare capacity buffer. This will in turn put more pressure on the world's supply/demand balance and thus increase the risk premium in oil prices in the short term as the oil market starts once again to worry about the spill-over effects if the protests spread to the oil-producing regimes of the Persian Gulf. The Persian Gulf accounts for around 30% of the world's oil production and controls over 50% of the proven reserves. In effect, it appeared the political risk premium was practically non-existent in the oil markets, with the CBOE oil volatility index only moderately higher in recent days (Chart 10).

As regards the European crisis, while the economies are flirting with recession, the recent statement by Mario Draghi to "maintain interest rates at present or lower levels for an extended

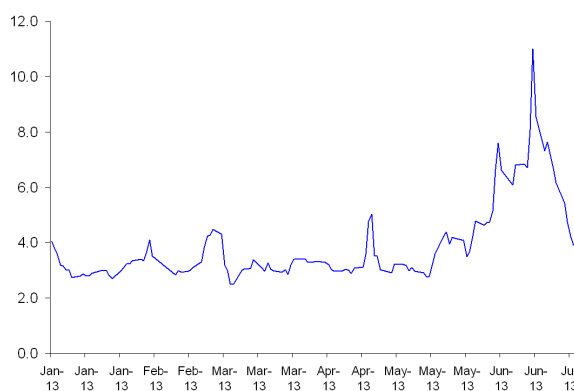
Chart 10. CBOE Crude Oil Volatility Index



Source: Factset

period of time" (July 8, 2013) marked a significant departure from a previous position of never pre-committing to future policy changes.

Chart 11. China Interbank Repo 1 week



Source: <http://www.shibor.org/shibor>

Finally, fears that China is headed for a credit crisis seem to be diminishing in conjunction with the retreat in the Shibor after a huge spike that pushed it above 10%. Fears of a market crash stem from China's credit-fueled construction industry which has come to dominate its economy by accounting for about 25% of all activities and 15% of all jobs. This rapid credit expansion has helped to drive China's economic rebound but it has increased the risk that some investments might be of poor quality and borrowers might default. Reining in "total social financing" and its growth should be a priority, according to the IMF.

Credit Markets: A Preview of Coming Attractions?

Bond investors experienced a rare feeling the past few months: losses. With the 10-year yield bottoming out at 1.62% on May 2, the 10-year Treasury increased to 2.50% as of July 1 (Chart 12). This is a 54% increase in a key benchmark rate. That is a dramatic move. The primary reason for this spike in rates was commentary from the Federal Reserve that they may begin to lower the amount of mortgage-backed securities and Treasuries that they purchase on a monthly basis from the current goal of \$85 billion/month. This “tapering” of purchases, as the market is calling it, would signal the gradual removal of a significant source of demand that is keeping rates so low. It would also signal that the FED believes there is an improvement in the economy which would result in rising interest rates.

Chart 12. 10-Yr. Treasury Yield, Year to Date

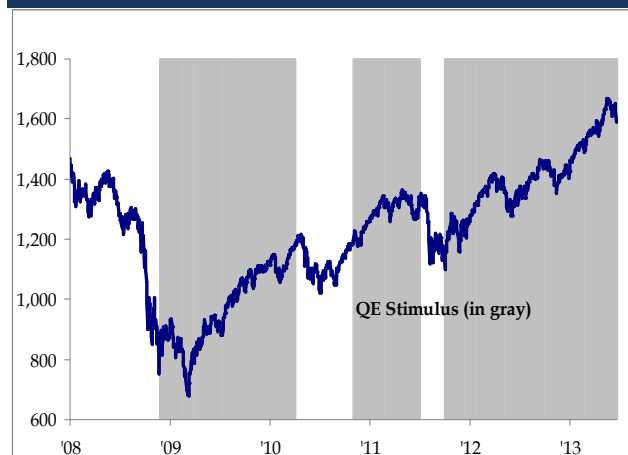


Source: Bloomberg

Make no mistake, the move in Treasury yields has been surprising in its velocity. The market has been weaned on this “QE” stimulus for the past several years and at the threat of a stimulus withdrawal the market is behaving like a baby whose mother is taking away its pacifier. There is some initial crying – or, in the market’s case, a selling of equities and bonds – but, just as the baby gets over its initial temper tantrum of losing the comforting pacifier, so too will the market get over its pacifier, monetary stimulus.

The skittishness of the market at the threat of a withdrawal of stimulus is clearly reflected in the chart below. Since heavy FED intervention began, the market has responded to FED withdrawals with sell-offs.

Chart 13. S&P 500 Performance & Periods of Fed Stimulus



Source: Strategas

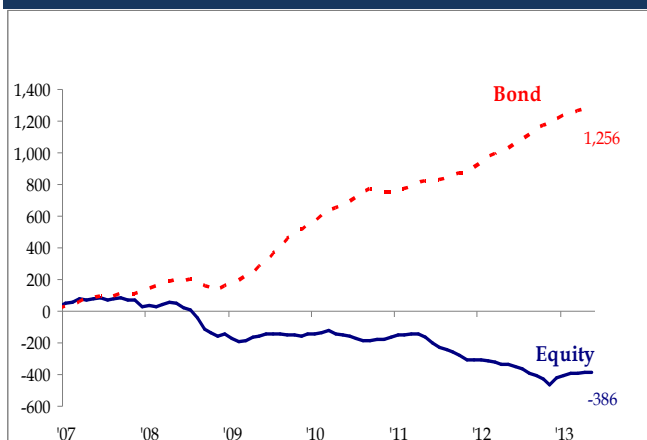
The important point of emphasis is not to panic and make rash decisions. Investors need to keep in mind that fixed income securities have two important characteristics: 1) they offer a steady source of income, and 2) they are largely uncorrelated with equities.

All of this underscores one of the themes we have been advancing: the risk in the bond market is asymmetric. This “asymmetric” risk/return profile is a result of rates being so low they have little room to contract and offer price appreciation, and plenty of room to rise and offer losses. We do not forecast interest rates as it has been proven to be a loser’s game among even the closest FED watchers. However, we continue to be of the opinion that investors should temper their total return expectations in fixed income to be more in line with coupon levels, in the low single digits. As it is prone to do, the market likely overreacted. Overreactions often lead to opportunities. Be prudent and do not panic. Remember to keep in mind the two chief characteristics of fixed income securities mentioned in the previous paragraph.

A “Great Rotation”? Not Just Yet.

So has the rotation out of fixed income and into equities begun? Not quite. While there has been an outflow of fixed income in recent weeks, it is far from an undisputed trend. It remains very challenging to handicap when or if a rotation out of fixed income will occur, although the recent upward shift in the yield curve certainly does not help the cause for fixed income. Equities have seen greater inflows in recent months but this has been more at the expense of money market accounts. We will continue to closely watch Chart 14 for signs of a consistent change in direction.

Chart 14. Cumulative Net Flows- Equity vs. Bond Mutual Funds, January '07 to June '13 (in billions)



Source: Strategas

Implications for Bond Portfolio Management: Strategies for Mitigating Bond Market Risk

Here are a few of the strategies we would like to reiterate from last quarter's piece that we are continuing to employ to mitigate the risks we have outlined:

- Keep a short duration portfolio. Accept the low real yields offered by the market until rates rise.
- NEW: Be opportunistic in adding to fixed income allocations should Treasury yields continue to rise. Take advantage of the market's panic selling as the economy is not strong enough to support Treasury yields climbing towards 3%.
- Diversify into non-U.S. interest rate based credit products.

- Invest in high premium priced “cushion” bonds, as their high coupons will soften the blow of rate increases.
- Diversify. Simple and straightforward. Increase exposure to other areas of the bond market to smooth out volatility.
- Find alternative income-producing asset classes (equities, real estate, etc.).
- Consider greater use of exchange-traded funds (ETFs), as their structure of broadly diversified holdings and continuously maturing bonds will allow for improved liquidity and diversification and *reinvestment at higher rates*.

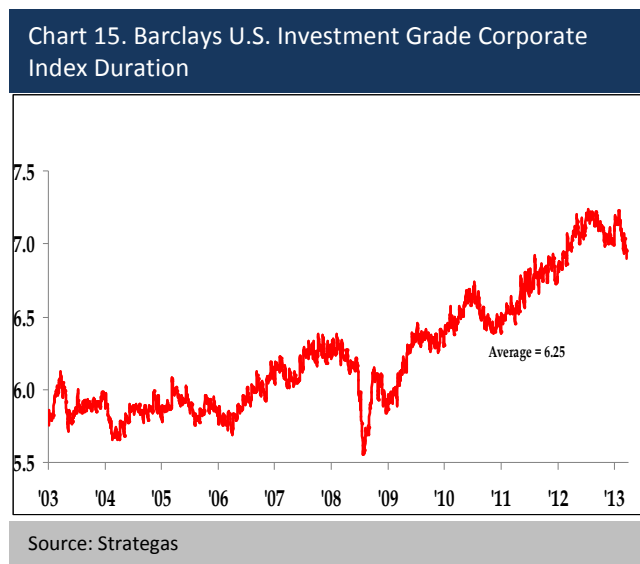
The Impact of Monetary Policy on the Bond Market: Is FED Policy Only Compounding Interest Rate Risk?

We keep with the same title as in last quarter's commentary to expand upon the theme of the unintended consequences of the FED's current approach to monetary policy. It is not intended to criticize the FED (after all, there are plenty of talking heads on television to play that role!), but rather to point out the implications of FED monetary policy and offer solutions to manage these risks.

An unintended consequence that many investors may be unaware of is “duration creep.” To explain this concept, we have to provide a definition of duration. Very simply, duration is an approximation of how sensitive a bond's price is to changes in interest rates. For example, if interest rates were to shift up by 100 basis points (1%) and a bond had a duration of 5, then, all things being equal, the bond's price would decline by 5%. If rates dropped 100 basis points, then a bond with a duration of 7 would increase in price by 7%. A bond's duration will be impacted by a number of factors which are beyond the scope of this commentary, but one key factor is the level of its coupon. In general, lower coupons result in higher durations and higher coupons in lower durations. The greater the duration of a bond, the greater the interest rate risk.

With interest rates so low, borrowers have been able to borrow at very low coupon rates. For example, Microsoft borrowed \$1 billion on April 25 at a rate of 2.375% for 10 years! These low coupon levels that are pervasive in the bond market are increasing the duration of bonds, thus interest rate risk. The average investor may fail to consider this. This “duration creep” is only compounding risk. We mitigate this risk through higher coupon, lower duration bonds, as well as sticking to our fixed income approach which diversifies across sectors through exchange traded funds (ETFs) to create an optimal mix of yield, duration, and credit risks to meet investment objectives.

To illustrate how the low rate environment has caused durations to steadily creep up, look at chart 15, which is the duration of the Barclays U.S. Investment Grade Corporate Bond Index.



We continue to emphasize that fixed income investors should avoid taking significant interest rate risk and should instead take credit risk, as credit spreads are offering reasonable compensation, and, as we have highlighted in past quarterly pieces, corporate credit metrics are strong (low leverage, high cash balances).

Themes In Action: Financial Repression

A consistent theme that we have been promoting is that U.S. policymakers are engaging in “financial repression.” Financial repression is a term coined by economists Edward Shaw and Ronald McKinnon in 1973. One of the primary aims of financial repression is to keep interest rates lower than they would be under normal market conditions in order to reduce interest costs, thereby reducing the cost of government debt service. One of the ways a government accomplishes this is by funneling capital that would ordinarily go elsewhere to themselves, often through regulation. This creates a source of stable demand which keeps interest rates suppressed.

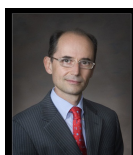
In light of this comes the news that swaps traders in the multi-trillion dollar over-the-counter derivatives market will now be required, per the Dodd-Frank Act, to post additional and higher quality collateral when engaging in swaps transactions. A swap is an agreement entered into by two parties to exchange the cash flows of one party’s financial instrument for the cash flows of the other party’s financial instrument. This additional required collateral is estimated by the Treasury Borrowing Advisory Committee to be anywhere from \$800 billion to \$4.6 trillion, with one estimate as high as \$11.2 trillion. And what is the highest quality collateral that will now be required? U.S Treasuries. Through regulation, the government has now found a new source of demand for government debt that will be anywhere from \$800 billion to \$11.2 trillion in size! This demand will help to support lower bond yields. Financial repression at work.

Portfolio Positioning

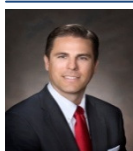
In our last edition of *Strategy Quarterly*, we stated that while absolute equity valuations were not particularly attractive relative to bonds, stocks seemed to offer a better risk-reward ratio for investors with an intermediate to long term horizon. Despite the recent spike in yields, we still believe equities are more attractive than bonds and they should be over-weighted in asset allocated portfolios. As the business cycle moves from the recovery phase to expansion phase, cyclically-oriented equities should perform better than low volatility, defensive stocks. In addition, despite a potential FED “tapering,” accommodative monetary conditions persist given the low absolute level of interest rates and the huge liquidity injected by global central banks over the last few years. This, in conjunction with the housing recovery, rising consumer confidence, and a resilient manufacturing sector, should result in a favorable backdrop for equities. As always, we advise investors not to chase trends or styles, but to adhere to a disciplined portfolio management approach that selects stocks based on persistent fundamental characteristics that drive performance over the long term.

In 2012 and so far in 2013, value stocks – defined as stocks trading at low cash flow multiples – have outperformed the market. Most of the returns from value stocks come from multiple expansion. As investors reassess the economic prospects, value stocks undergo a re-rating whereby their multiples expand from depressed levels. As the recovery phase matures and transitions to the expansion phase, growth-oriented, profitable companies should start outperforming, driven by business and sustainable earnings growth.

For fixed income, we continue to reiterate our refrain of the past few quarters, which is that return expectations should be lowered, as catalysts for further upside potential (lower rates and credit spreads) are limited. The recent upward shift in the yield curve is a reminder of just how fast rates can change and bond returns can suffer. However, investors should consider being opportunistic by taking advantage of higher yields as most of the selling is overdone. Fixed income always represents a tradeoff between credit and interest rate risk. We firmly believe investors should take on credit risk and reduce interest rate risk by shortening durations. Falling leverage, rising cash levels, and improving credit metrics support this view.



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.



Portfolio Management Ryan Kuyawa, CFA is a Portfolio Manager & Fixed Income Trader for Cypress Capital Group & Cypress Trust Company. He is responsible for security selection, yield curve positioning and overall fixed income strategy. In addition, he performs equity research and is a member of the Investment Policy Committee which directs the firm’s overall investment outlook.

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