Strategy Quarterly

First Quarter 2015

CYPRESS TRUST COMPANY

Executive Summary

❑ Inflation has been trending lower and lower and does not show any signs of turning up anytime soon. Sub-par economic growth, deflation, and international political uncertainty represent perhaps the greatest risks to the ongoing economic recovery.

❑ Although fiscal and perhaps monetary policy will be more restrictive going forward, there are several positive factors supporting economic growth: declining unemployment, improving household balance sheets, rising median family income, strong corporate cash flows and capital investments.

❑ Economic and corporate data seem to suggest that profitability at U.S. companies may have reached its peak for the current economic expansion. And while valuations are not particularly expensive and are still supported by robust free cash flows, in this phase of the cycle it makes sense to re-allocate a portion of the equity portfolio towards non-cyclical, defensive shares with attractive valuations and good growth rates.

❑ With the U.S. and most global sovereigns facing non-existent inflationary pressures which have only been exacerbated by the drop in oil prices, inflation expectations have plummeted in the U.S. Consequently, so have interest rates. The recent drop in oil is the primary culprit for the drop in rates and presents a strong headwind for materially higher interest rates in the near future.

❑ The sell-off in oil brought some value back into the credit markets by introducing volatility. Given a positive domestic growth picture, strong balance sheets, and resilient earnings and cash flows, it is hard to see the disruption in the energy sector spreading to other business sectors. It will likely pay to take advantage of this recent volatility.

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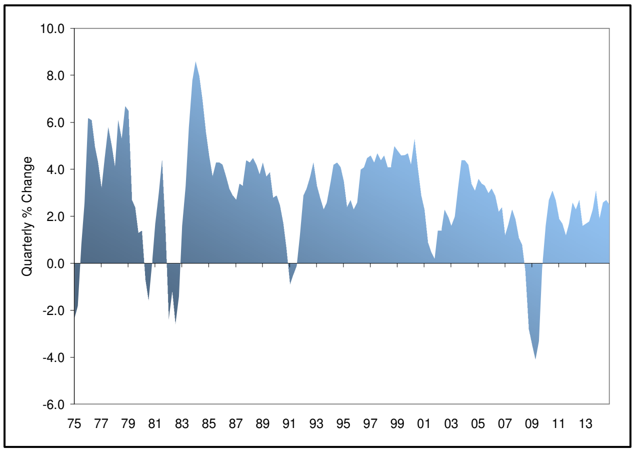
Economic Backdrop

Since the 2008 credit crisis investors have perceived the recent economic recovery as a sluggish one, characterized by anemic growth. Indeed, as Chart 1 shows, GDP growth has been on average below past recoveries and still has not reached typical levels associated with economic expansions.

Chart 1. Real GDP - Quarterly Percentage Change



Source: Federal Reserve

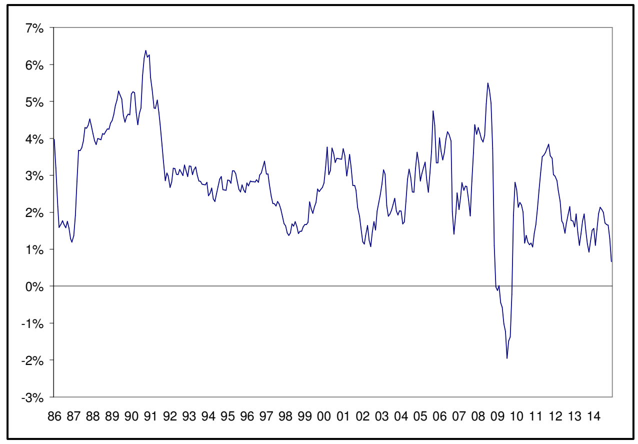
As we stated in past issues of this publication, we see this low rate of growth as carrying some positive implications for equity investors. In past business cycles, as the economy moved from recovery to expansion phase, growth acceleration was invariably accompanied by rising inflation. As inflation picked up and economic activity overheated, the monetary authorities stepped in by increasing interest rates in an attempt to avoid rampant inflation.

Such intervention usually signaled the beginning of a cycle of higher interest rates that lasted several quarters. These rising rates cycles preceded the peak in economic and corporate earnings growth and ultimately caused the next contraction and recession phases of the business cycle.

However, as Chart 2 shows, inflation has been trending lower and lower and does not show any signs to turn up anytime soon. Thus, the current contained rate of growth in conjunction with the absence of inflation removes the risk to the market from a restrictive monetary policy stance.

At the opposite spectrum of the analysis, a case for "deflation" risk could be made based on global deflationary forces. In most advanced economies, for example, there is still a very large output gap, with economic output and demand both well-below potential. In addition, there is considerable slack in labor markets with too many unemployed workers chasing too few available jobs.

Chart 2. Consumer Price Index Y/Y % Change



As a result, both final demand and corporate pricing power are weak. Other factors fueling further deflationary pressures are continued slack in real estate markets, weak oil and gas prices, China's growth slowdown and consequent weakened demand for a broad range of commodities, and cement and construction materials.

Finally, incongruent fiscal policies around the globe have resulted in decreased effectiveness of monetary stimulus. In fact, the Eurozone, the U.K., Japan - and in part the U.S. - are all pursuing varying degrees of fiscal austerity and consolidation. Thus, despite global aggressive monetary easing, in the absence of fiscal policies addressing insufficient aggregate demand, deflationary forces may persist longer than most investors previously thought.

In conclusion, rather than inflation and/or higher interest rates, sub-par economic growth, deflation, and international political uncertainty represent perhaps the greatest risks to the ongoing economic recovery.

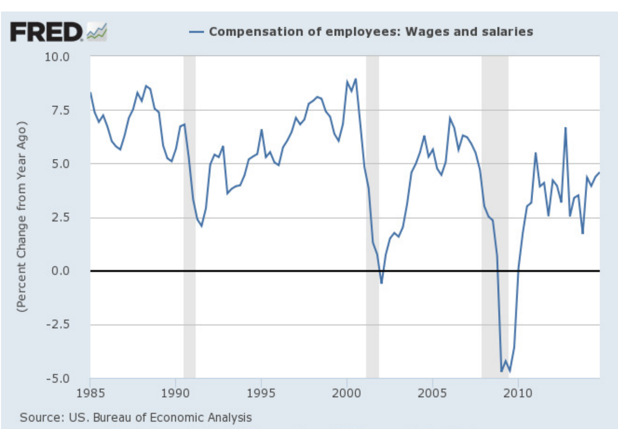
Although both fiscal and perhaps monetary policies will be more restrictive going forward, there are several positive factors supporting economic growth. First, the job market has been improving with the unemployment rate falling to below 6% from a peak of 10% in 2009 (Chart 3).

Chart 3. Wages and Salaries – Y/Y % Change

Source: Federal Reserve

Employees' compensation (Chart 4) is also finally showing some decent increases from the lowest points in 2009. Household balance sheets have been improving with household net worth now well above its previous record. The household debt service burden has also declined below 10% from record highs in 2007 (see Chart 5).

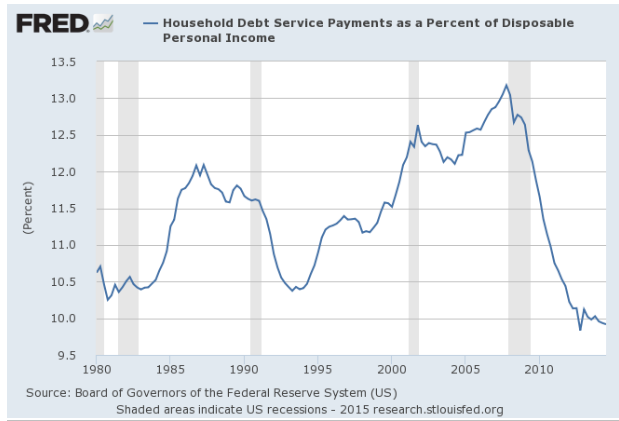
Chart 4. Wages and Salaries – Y/Y % Change



Source: Federal Reserve

Gains in the household sector have also recently broadened. Similar to past recoveries, it has often taken several years of recovery before real income gains extended to the median family. The early 1980s recession ended in August 1982, but it was not until 1984 that median incomes began rising.

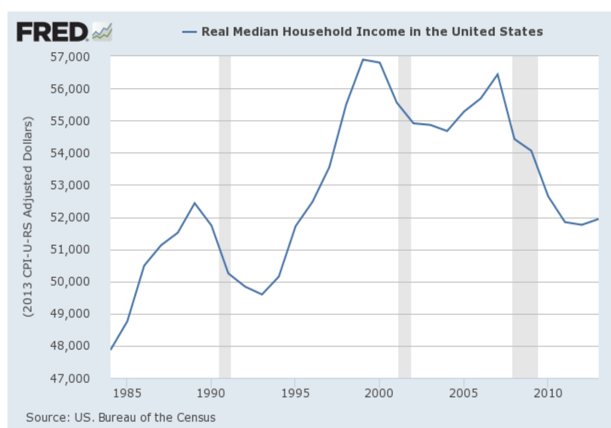
Chart 5. Household Debt Burden



Source: Federal Reserve

Likewise, the early 1990s recovery did not enhance median incomes until 1994 and the early 2000s recovery did not broaden until almost 2006 (Chart 6). In the current recovery, real median household income continued to decline until 2012 and did not really begin rising until late 2013. With income gains now finally boosting the average household, overall consumer spending should appreciably improve.

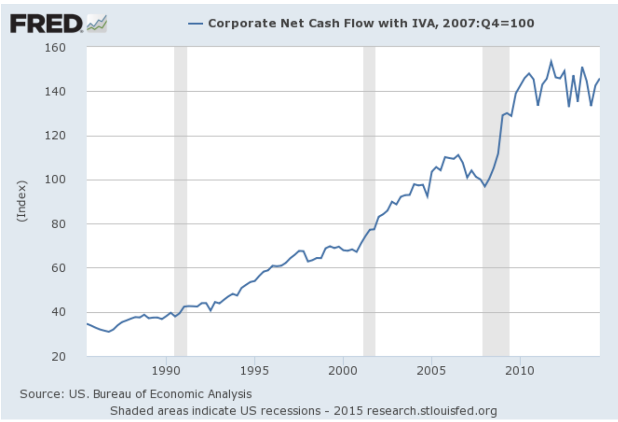
Chart 6. Real Median Household Income



Source: Federal Reserve

Another positive force is represented by the potential capital spending increases suggested by all-time high corporate cash flows (Chart 7). At this stage of the cycle, capital investments are extremely important to support the recovery and to propel the economy into a sustainable expansion.

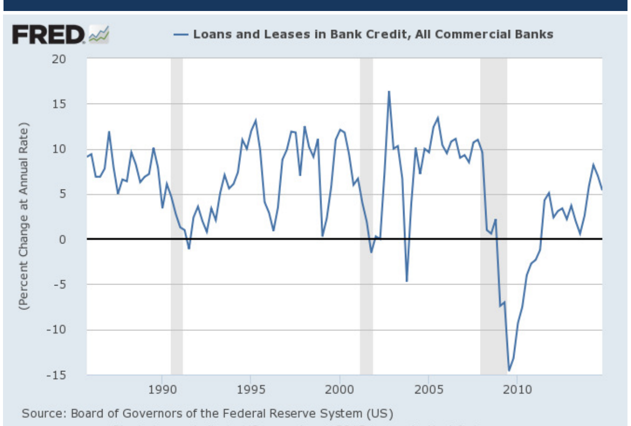
Chart 7. Corporate Cash Flows



Source: Federal Reserve

In parallel to higher corporate profits, the credit creation process has been steadily improving and it has accelerated more recently (Chart 8). Increased availability of credit should contribute to faster growth.

Chart 8. Total Bank Loans



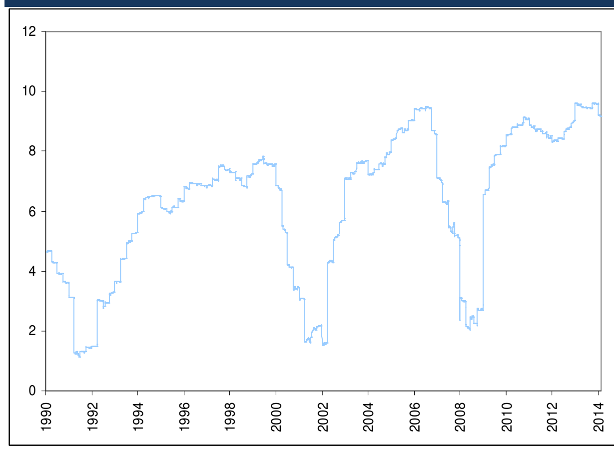
Source: Federal Reserve

Finally, the recent collapse in oil prices is expected to be a net positive for the economy as lower gasoline prices supports consumer spending. In addition, many manufacturing industries should benefit from lower input costs such as oil and derivative materials.

Valuation and Corporate Earnings

Chart 9 seems to suggest that profitability at U.S. companies may have reached its peak for the current economic expansion. Investors should not rely on further margin expansion to justify market valuations. Although nobody knows exactly when

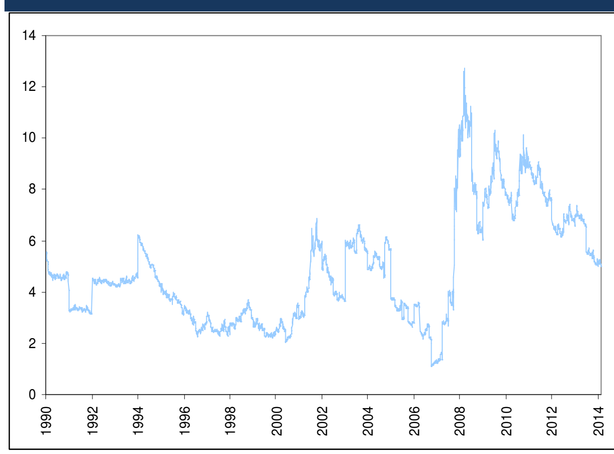
Chart 9. Net Profit Margins



Source: Bloomberg

we will reach peak margins as the business cycle progresses into the expansion phase, we do know that we are closer to the peak. And while valuations are not particularly expensive and still supported by robust free cash flows (Chart 10),

Chart 10. Free Cash Flow Yield – S&P 500



Source: Bloomberg

in this phase of the cycle it makes sense to re-allocate a portion of the equity portfolio towards non-cyclical, defensive shares with attractive valuations and good growth rates.

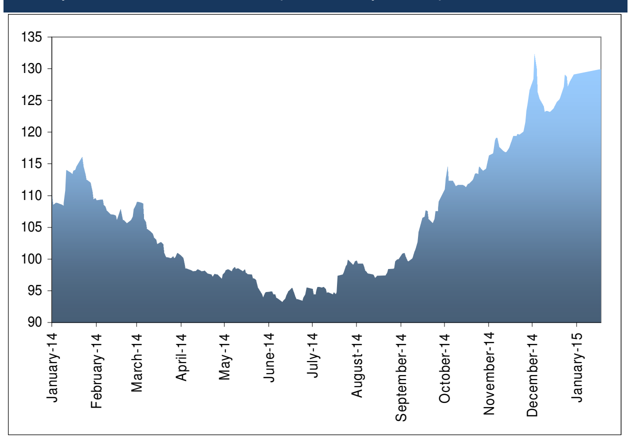
Seeing the Positives: The Credit Markets & The Drop in Oil

While the big story in the global capital markets has been the precipitous drop in the price of oil and the increased volatility as a result of this decline there are some distinctly positive impacts that can be drawn from this event.

1. Valuations in corporate credit are now more attractive.
2. The high yield - or junk bond - market no longer looks overheated.
3. Cost structures for the majority of companies will decline, a positive for cash flow, as petroleum costs are a significant input cost for most firms.
4. The sell-off may make investors more disciplined and less complacent.

The drop in the price of oil caused credit spreads in the bond market to move up quite a bit over the past couple of months. Unsurprisingly, this movement was led by the energy sector. With credit spreads widening, corporate bond valuations have become more attractive.

Chart 11. Investment Grade Credit Spreads, Barclays Corporate Credit Index (in basis points)



Source: Barclays Capital

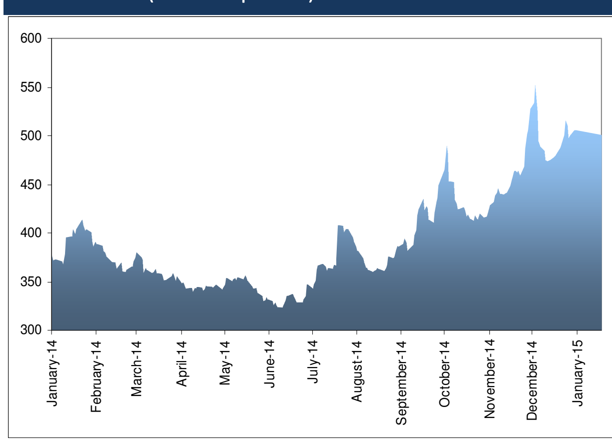
The drop in the price of oil caused credit spreads to increase 40% from 94 bps in the summer to the current 130 bps area. Historically, the bottoming in credit spreads has been in the 80-90 bps range signifying that the market was particular pricey at those moments.

With the recent sell-off, spreads, and thus valuations, are now more in line with longer term historical levels. Subsequently, they are more attractive.

One area of concern in the bond market was the high yield or so-called "junk" bond area. Investors were pouring into junk bonds to reach for yield in a low interest rate environment. This was exacerbated by the monetary policy stance of the Federal Reserve. As the name suggests, junk bonds are those issued by companies with limited financial strength; they offer higher yields to entice investors and to compensate them for additional risk they assume. Many investors were either unfamiliar with the risks or chose to ignore them. If we go back to our concept of a Risk Cycle (see below) moving between fear and greed, the junk bond market was seeing more and more greedy investors. An element of fear has returned which is healthy. It brings with it discipline, a focus on risk, and better valuations. We will see how long this lasts.

Fear	Greed
▪ Return Of Capital	▪ Return <u>On</u> Capital
▪ Don't lose my money!	▪ Make me money!
▪ This pain will never end!	▪ The good times will never end!
▪ Worry about being in the market.	▪ Worry about <u>not</u> being in the market.
▪ Risk dominates risk/return objective.	▪ Return dominates risk/return objective.
▪ Depressed asset prices.	▪ Peaking asset prices.

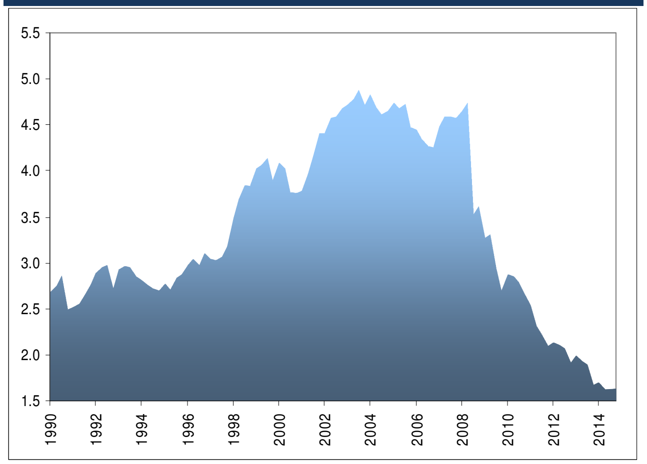
Chart 12. High Yield Credit Spreads, Barclays High Yield Index (in basis points)



Source: Barclays Capital

Outside of the energy sector where credit quality is deteriorating, fundamentals still remain strong with debt levels very manageable, cash balances very high and cash flows continuing to improve. There will be some idiosyncratic risk that was not previously present in the debt market related to the smaller, less capitalized oil and gas companies, but by and large creditworthiness is still quite solid. As noted in Chart 13, leverage among S&P 500 companies remains very low, at the lowest levels in over 25 years.

Chart 13. S&P 500 Net Debt/ EBITDA



Source: Bloomberg, Cypress Trust Company

You would be hard pressed to find a business that does not in some way rely on petroleum-based products as an input cost. The 50%+ drop in oil will undoubtedly lower a key cost for most of corporate America. This should boost earnings and cash flows.

Big picture, the sell-off in oil brought some value back into the credit markets by introducing volatility. That is not a bad thing. Given a positive domestic growth picture, strong balance sheets, and resilient earnings and cash flows it is hard to see the disruption in the energy sector spreading to other business sectors. It will likely pay to take advantage of this recent volatility.

The "Unknowns"

Unknowns in investing are ever present. The unknowns are those events which we cannot predict or rarely foresee. It is the unknowns that can really harm you in investing. For example, the 55% drop in the price of crude oil since the summer would certainly qualify as an unknown. Who in the summer of 2014 was calling for such a precipitous drop in the price of oil? Who foresaw this? Essentially nobody. Although the impact on the markets has been dramatic. As of this writing we have another unknown that popped up, the Swiss National Bank abandoning a 3-year policy of capping the Swiss franc against the Euro. An action no one saw coming which shocked the markets. The day the news was announced the Swiss equity market was down 9% and the Swiss franc was down 10%+. If you are a Swiss investor or have exposure to Swiss companies this is certainly a shock. So how do we account for these "unknowns"? Here are a few simple suggestions:

1. Prepare, don't predict. You can't predict these events. Come to this realization and don't listen to those who tell you they can predict.

2. Prepare your portfolio:

▪ Maintain your asset allocation. Don't compromise your asset allocation to chase high returns that you missed.

▪ Stay diversified.

▪ When rates are low don't chase yield by moving into riskier, higher yielding asset classes.

▪ Don't compromise on quality. If you are accustomed to owning the highest quality companies due to their stability, dividend history, etc., keep it that way. Don't compromise.

▪ Valuations matter! They matter a lot. The single biggest determinant of your future rate of return is the price you pay. Buy at an attractive valuation, not when an asset has been bid up by euphoria. Remember the Buffett quote, "You pay a high price for a cheery consensus."

3. Stay invested. Panic is not a strategy. The academic evidence is irrefutable that timing the market is a loser's game. Missing just the best 5-10 days in the market can dramatically reduce your return potential over time. Those who stay invested almost always do better than those who sell out due to panic.

Failing to adhere to the points above can only magnify your potential losses when these "unknowns" strike again.

What is the Deal with Interest Rates?

Lastly, we follow up with a theme we have written about in the last few quarters which has current implications – namely, the case for lower than expected interest rates. While we avoid predicting the future of interest rates, the prevailing sentiment seems to be that rates *must* return to historical levels. We would reiterate a few points to counter that argument. Looking out over the available options of investment grade sovereign debt, at 1.77% (as of 1/15/15) the 10 year U.S. Treasury actually represents good value vs. comparable sovereigns, as shocking as that sounds. Global quantitative easing, particularly in developed nations, and the absence of economic growth and thus inflation has driven yields to rock bottom levels. For pools of capital looking for safety, liquidity, and some yield, U.S. debt offers the best choice, bar none. Look at Chart 14 below. Where else are you going to go for safety, liquidity, and a little yield? This is unlikely to change any time soon. Of the 19 countries noted below, only 4 offer yields higher than a 10 year Treasury. Of the 4, two do not offer safety (Greece & Portugal) and the other two can not come close to matching the liquidity of a Treasury. Not much competition - which is a good thing for Treasuries.

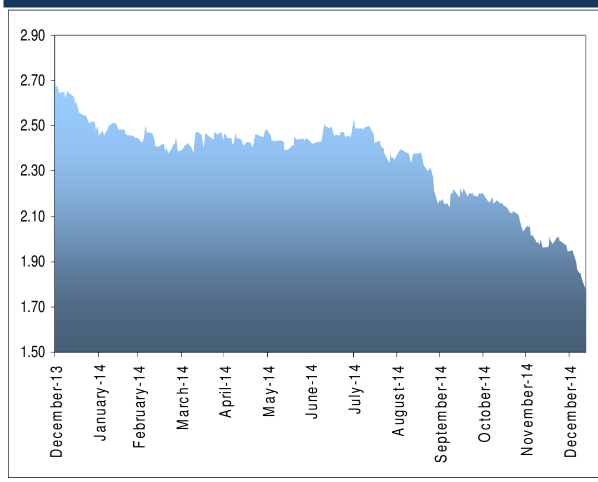
Chart 14. Sovereign Bond Yields- 1/15/15

	10 Year Govt Yields
US	1.77%
Switzerland	0.06%
Japan	0.25%
Europe	0.25%
Germany	0.42%
Netherlands	0.48%
Belgium	0.63%
France	0.66%
Denmark	0.68%
Sweden	0.78%
Ireland	1.29%
Norway	1.40%
Canada	1.49%
UK	1.51%
Spain	1.58%
Italy	1.71%
Portugal	2.61%
Australia	2.67%
New Zealand	3.46%
Greece	8.97%

Source: FactSet Research Systems

Interest rates are a function of inflation. Higher inflation results in higher rates with a premium for inflation embedded in global interest rates. With the U.S. and most global sovereigns facing non-existent inflationary pressures which have only been exacerbated by the drop in oil prices inflation expectations have plummeted in the U.S. Consequently, so have interest rates. This is hardly a coincidence as the inflation premium has nearly vanished. While Fed monetary policy tightening could lead to higher rates in 2015, that is more likely to impact short-term rates. The Fed has less ability to manipulate longer rates. The recent drop in oil is the primary culprit for the drop in rates and presents a significant headwind to materially higher interest rates.

Chart 15. Fed's 5 year Forward Breakeven Inflation Rate



Source: Bloomberg, Cypress Trust Company

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