Strategy Quarterly

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Executive Summary

❑ Volatility has dominated the beginning of 2016 on concerns of decreasing growth in China and the global economy, in addition to fear of higher interest rates. However, strong corporate fundamentals, good liquidity and a still positively-sloped yield curve do not signal an imminent risk of recession and an associated prolonged bear market.

❑ Although investors should prepare for continued volatility, we believe that the massive fall of oil and commodity prices, international accommodative monetary policies and recent currency devaluations, will eventually drive a rebound in global economic activity. That could support equity markets, although stock selection and a focus on defensive qualities will continue to be crucial as we enter the mature phase of the business cycle.

❑ Today's backdrop of tepid economic growth and subdued inflation should contain the Fed's pace of future interest rate increases. Historically, the initial rate hikes have been generally implemented during the mid phase of the expansion of the business cycle and have coincided with a broadening of economic gains and with a respectable stock market performance.

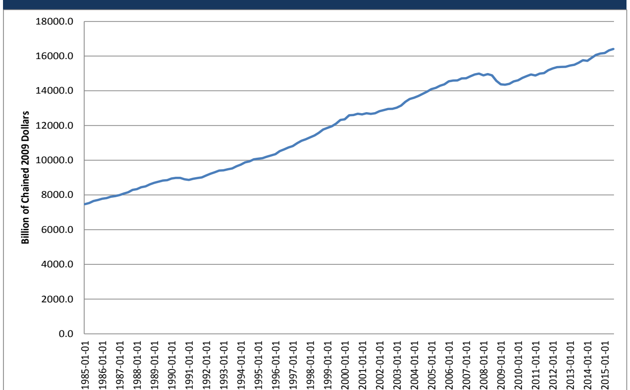
❑ The current economic expansion that started in 2008 has been characterized and supported by persistent slack in economic resources as indicated by a negative output gap. However, continued job gains have recently pushed down unemployment to 5%, a level that has been historically associated with full employment. At this point, continued demand for products and services could drive wage pressures and restrain corporate earnings growth and thus limit further stock price gains.

❑ We remind investors that the main role of fixed income in a balanced portfolio is capital preservation and only secondarily income generation. During equity market declines or economic slowdowns, bonds have historically offset capital losses in a balanced portfolio by preserving or even increasing in value.

Economic Backdrop

Due to its persistent low pace of growth, the current economic recovery has been unanimously considered unsatisfactory. However, a look at some economic metrics reveals that the U.S. economy has made tremendous progress since the bottom of 2008. For example, Real Gross Domestic Product is currently about 10% above the most recent peak at the end of the last recovery (see Chart 1). Likewise, Nominal Personal Income is 18% above its lowest reading of 2009 (Chart 2).

Chart 1. Real Gross Domestic Product

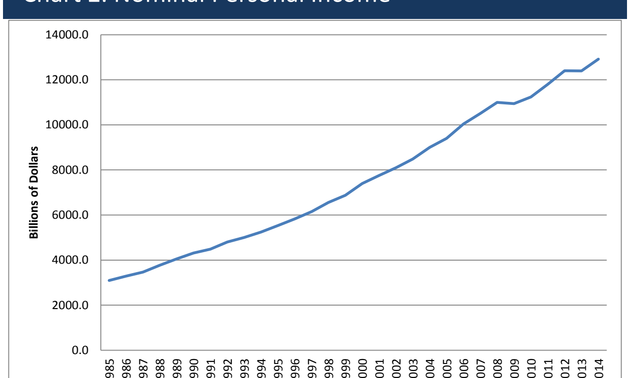


Source: Federal Reserve

Household balance sheets are in good shape with household net worth at an all-time record high (Chart 3).

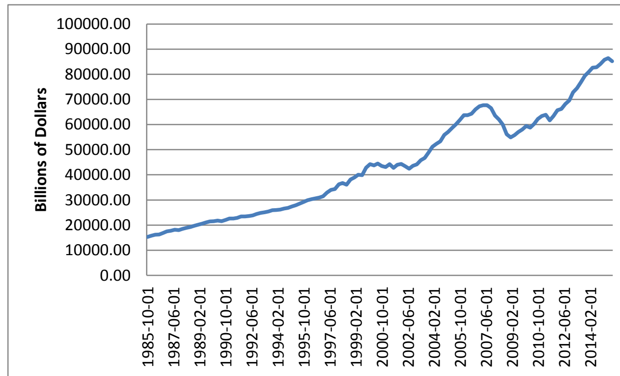
Conversely, the Household Debt Service Ratio - the ratio of total required household debt payments to total disposable income – is at an all-time record low over the period this indicator has been available (Chart 4).

Chart 2. Nominal Personal Income



Source: Federal Reserve

Chart 3. Household Net Worth



Source: Federal Reserve

Thus, while public perception of the state of the economy is quite negative, the actual numbers show that the economy has gone a long way from the abysses of the financial crisis and it appears today in much better shape than commonly thought.

Although overall growth this year is expected to be below historical averages, we believe that the massive fall of oil and commodity prices, still accommodative monetary policies around the world and recent currency devaluations, will eventually bring a rebound in global economic activity.

And while weakness persists in the manufacturing and oil industry, overall corporate profitability is strong with historically wide profit margins. Solid job growth underpins real income growth and the all-important U.S. consumer sector.

Chart 4. Household Debt Service Ratio

Source: Federal Reserve

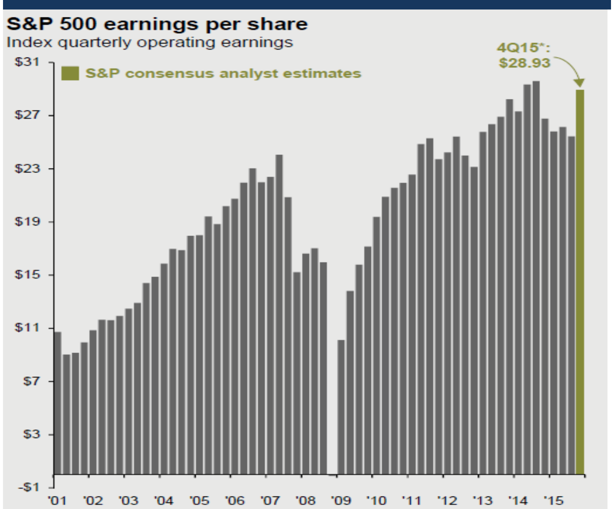
Corporate Earnings and Equity Valuation

As we have highlighted in past issues of this report, persistent economic slack has kept the economy from intensifying inflation pressures and has allowed companies to increase and maintain historically high profit margins. However, as capacity utilization increases and unemployment declines to the significant 5% level, companies may soon start to confront cost-push pressure and profit margin erosion.

The recent collapse of commodity and oil prices and a still subdued increase in wages may delay that negative effect and allow corporations to maintain elevated levels of profitability for longer than generally expected at this phase of the cycle. This suggests the economic recovery in the U.S. could still have legs.

Unfortunately every cycle is different from the past in amplitude and duration due to the interplay of a myriad of global macro and policy factors.

Chart 5. Aggregate Earnings Per Share – S&P 500



Source: J.P. Morgan, S&P

Chart 6. S&P 500 Profit Margins

Source: Fidelity

Thus, even under a decent revenue growth scenario, corporate earnings growth may be much less strong than in the past few years. This phenomenon is not apparent yet as aggregate corporate profit margins are still improving (Chart 6). In fact, according to analysis by J.P. Morgan, despite a negative contribution from the Energy sector, net margins were at 9.0% for the S&P 500 companies. Excluding the Energy sector margins are currently at an all-time record high of 10.7%.

Wide margins signal that business expansion may be still firmly in the mid-cycle phase, characterized by good top-line growth and resilient margins. The transition from a mid-cycle phase to a late-cycle phase typically involves a pickup in inflationary pressures; in particular, commodity prices and wages tend to accelerate. Rising input costs eventually pressure profit margins and lead to tighter credit conditions and more restrictive monetary policy.

For example, in the U.S. divergent trends within the economy with weak growth in manufacturing and robust growth in the services sector are making it difficult to model future corporate earnings.

In addition, internationally, other economies are struggling. Japan is back in recession, while Europe needs economic reforms to unlock its growth potential. Similarly, many emerging market economies need to implement structural reforms to create sustainable growth. Brazil is in a severe downturn while China is slowing significantly. Monetary policies are also diverging, with the U.S. at the initial stage of a rate hike cycle and Europe and Japan easing.

These economic and policy divergences make current cyclical trends very challenging to read and do not insure that corporate profitability will evolve as in past business and economic cycles.

Capital IQ recently reported (see Chart 7) that aggregate Q4 2015 S&P 500 EPS are estimated to be $28.70, a decline of 6.1% on a year-over-year basis. Only three of the 10 S&P sectors are expected to post positive earnings growth for Q4: Telecommunications Services (17.9%); Consumer Discretionary (7.5%); and Health Care (5.6%). Energy (-70.4%) continues to weigh heavily on the Index.

Other sectors projected to show earnings declines include Materials (-24.4%), Technology (-4.7%), Consumer Staples (-3.6%), Utilities (-1.6%), Financials (-1.4%) and Industrials (-0.5%).

These estimates result in aggregate expected EPS growth of 6.7% in 2016 for the companies in the S&P 500 Index. We believe these estimates may prove achievable as consumer spending should support growth of earnings of sectors outside the energy and materials sectors where weakness may persist.

In fact, low energy prices, employment and income growth, and the effects of the strong U.S. dollar on import prices should all boost consumer spending, offsetting continued weakness in industrial demand.

And although the Federal Reserve is likely to continue gradually raising interest rates, the monetary environment should remain supportive, as the European Central Bank, the Bank of Japan, and a number of emerging market countries continue to pursue accommodative policies.

Even the Energy and Material sectors could eventually rebound as year-over-year earnings comparisons should grow less onerous for them as we move into the second half of 2016—assuming commodity prices and exchange rates stabilize.

As Chart 8 shows, while net profit margins are holding up at historically high levels, top-line growth has been declining from the healthy levels reached over the last few years due to a combination of a weak manufacturing sector, strong dollar and global deflationary forces.

A decent reacceleration of demand-driven revenue growth on steadily increasing consumer spending and a global economic rebound could result in high single-digit earnings growth even without further margin expansion.

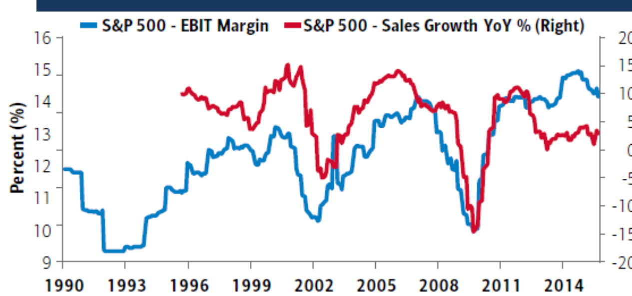
Chart 7. S&P 500 EPS Growth

	EPS Growth %			
S&P 500 Sector	Q4 2015	Q1 2016e	2015e	2016e
Consumer Disc.	7.5	15.5	12.3	11.6
Consumer Staples	(3.6)	1.9	0.0	6.3
Energy	(70.4)	(55.2)	(60.3)	(11.9)
Financials	(1.4)	2.3	7.4	9.1
Health Care	5.6	5.7	13.3	9.4
Industrials	(0.5)	0.0	3.6	5.3
Info. Technology	(4.7)	0.5	3.4	7.1
Materials	(24.4)	(1.0)	(5.8)	10.6
Telecom. Services	17.9	5.3	11.4	1.9
Utilities	(1.6)	2.3	2.4	3.1
S&P 500	(6.1)	0.0	(1.1)	6.7

Source: S&P Capital IQ

Source: S&P Capital IQ

Chart 8. Margins and Sales Growth – S&P 500



Source: Merrill Lynch

From a valuation perspective, the S&P 500 was recently trading at about 16x forward P/E ratio, a level in line with its historical average since 1990. The price-to-book ratio was recently at about 2.6x, slightly below its historical average of 2.9x.

Against a backdrop of a potential series of interest rate increases and record high profit margins, such full valuations indicate little or no room for further multiple expansion.

Despite the headwinds there are few alternatives to equities, as they remain a source of capital growth and income and have attractive valuations relative to bonds.

We believe that at this stage of the business cycle, and given the current market backdrop of high macro risk and full valuations, equity investors should focus on high-quality and dividend-paying stocks of companies with strong balance sheets, low debt leverage and resilient profitability.

Your Annual Estate Planning Health Check-Up List

By Anita Calabro, Vice President and Trust Officer

Financial wellness is essential for you and your family's overall health and wellbeing. Everyone's prescription for a healthy financial condition is different. It all starts with a checkup to identify where you may be most at risk from a financial standpoint.

As with every New Year we reflect on what happened in the past and make adjustments as needed. Some of them may be to your investments, others may be to address changes in your estate plan. Some practical considerations that you may think of are:

Death or Incapacity

•Who would serve in my stead in the event of incapacity or death?

•Who would make my financial and health care decisions if I were unable to do so, and are those agents assigned to care for my financial or health care protection willing and able to step in today?

•Special needs planning for a child, spouse or other family member: Who would I trust to help with my family's needs?

Second Marriage

•What are my current estate plans for a new spouse and/or children?

•Have I planned for children from another marriage?

•Do I plan to financially care for step children?

Inheritance

•Do I need to plan for an inheritance event personally?

•Do I need to plan for an inheritance for a spouse or a family member from my estate?

Retirement

•Have I reviewed my pension, IRA and stock option plans? Is my beneficiary information current?

•Am I up-to-date about any taxable consequence as it relates to my retirement planning?

Charitable Planning Now and Beyond

•Tax strategy planning as it relates to charitable gifts.

•Do I know exactly where my charitable gifts will go?

Tax Planning

•How can I reduce a taxable consequence to my overall estate plan?

•Have I leveraged my gifting options?

•Do I know who my pay-on-death beneficiaries are?

Asset Titling

•Have I "funded my trust?"

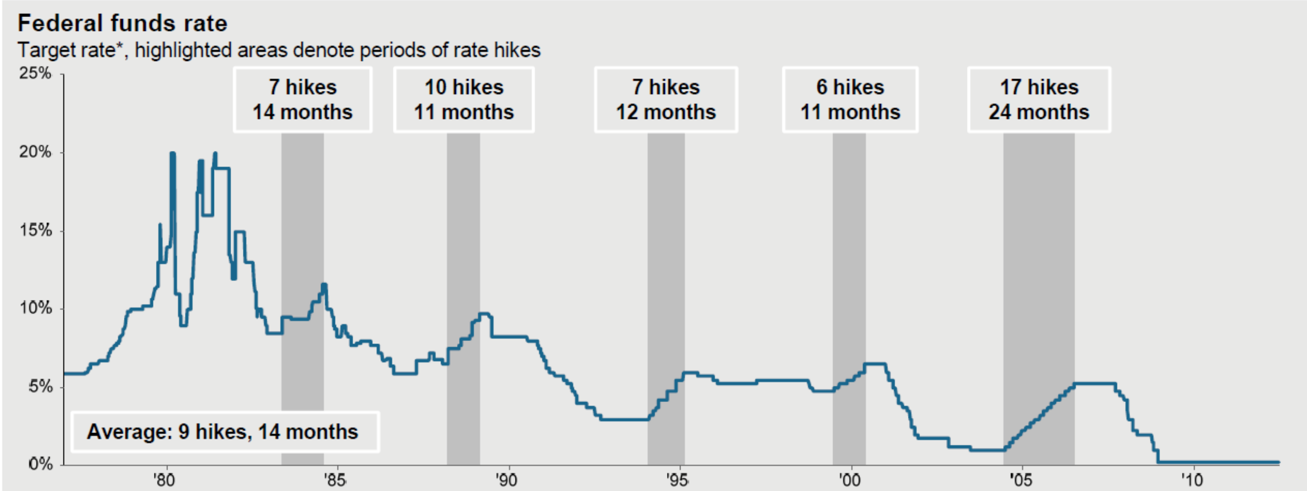
•Is my real estate titled correctly for all of my real property?

Your attorney, CPA, trust officer, and investment officer all work together as your team of trusted advisors – a team of specialists, each with a specific role in ensuring your good financial health. We at Cypress Trust Company work alongside your CPA and attorney to help you achieve the healthiest financial condition you and your family deserve. We are client-centric, focused and accessible. We are local in every market we serve and have the authority to facilitate timely responses to your requests. Our one-on-approach means that an Investment Officer and Trust Officer team is assigned to each relationship and we offer customized solutions for each client tailored to his or her individual and family needs.

Fixed Income

Many investors see the Federal Reserve's interest rate increase after a long period of zero rates as the first of a series of upward moves over the following several quarters. After two decades of good returns, bonds are now seen as vulnerable to inflation and interest rate risks and some investors are projecting much lower or even negative returns from this asset class. However, an empirical analysis of the impact of rate hikes on stocks and bonds reveals that bonds provided still positive total returns on average during the last five rate increase cycles since 1983 (see Chart 9). Interestingly, the average returns for the 2-year and 10-year treasury bond were not much lower than those for the S&P 500 Index over those five cycles. We always remind investors that the main role of fixed income in a balanced portfolio is capital preservation and only secondarily income generation. During equity market declines or economic slowdowns, bonds have historically offset capital losses in a balanced portfolio by preserving or even increasing in value (see Chart 10).

Chart 9. Historical Impact of Fed Tightening

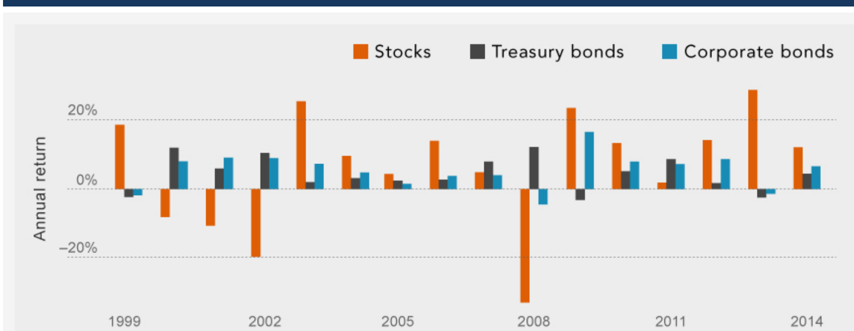


Market reaction during previous rate hiking cycles

	May 1983 – July 1984	March 1988 – February 1989	February 1994 – February 1995	June 1999 – May 2000	June 2004 – June 2006	Average
Change in interest rates						
Federal funds rate	3.13%	3.25%	3.00%	1.75%	4.25%	**3.08%**
2-year Treasury	3.11%	2.27%	3.05%	1.21%	2.38%	**2.40%**
10-year Treasury	2.74%	0.85%	1.89%	0.49%	0.51%	**1.30%**
S&P 500 return	-9.6%	6.8%	-2.1%	8.5%	12.0%	**3.1%**
U.S. dollar	10.4%	1.7%	-4.8%	3.4%	-5.8%	**1.0%**

Source: J.P. Morgan

Chart 10. Performance of Stocks and Bonds



Source: Fidelity

We are confronting potentially increasing rates over the next several quarters after a long period of declining rates that started in the mid 1980s. Although we expect lower returns than in the past from bonds, we are also aware that investment-grade bonds rarely lose money over longer time periods, even when rates rise. We believe that bonds play a fundamental role in most portfolios, regardless of the rate environment.

Massimo Santicchia is the Chief Investment Officer for Cypress Capital Group, Cypress Trust Company and Crest Investment Partners. He directs the investment policy and strategy as well as develops and manages quantitative equity strategies. Santicchia has 18 years of investment experience including: S&P Investment Advisory Services LLC, as creator and portfolio manager of JNL/S&P 4 funds and co-manager of the JNL/S&P Managed and Disciplined funds.