CYPRESS
CAPITAL MANAGEMENT

A Review of 2017

EQUITY MARKETS

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2017 proved to be another strong year for equity markets globally. Emerging Markets led the way, up 25.6% in Canadian dollars terms, followed by the developed Asia and European markets which gained 17.1% . Contrary to President Trump's boasts about the strength of the U.S. stock market, the U.S. market trailed global markets, up 13.6% in CDN$ terms. The Canadian market lagged almost all other major equity markets and returned 9.1% in 2017. The Canadian market was once again impacted by the high concentration in the Energy and Materials sectors, which returned -7.0% and 7.7% respectively and by the very limited exposure to the Technology and Health Care sectors, both of which performed well.

Bonds continue to look expensive to us both in relative and absolute terms.

CURRENCY AND INTEREST RATES

The Canadian dollar, which started the year at 0.74US$ fluctuated quite dramatically in 2017. At one point in September the dollar rose to 0.83US$ before falling back to end the year at 0.79US$. This strengthening of the Canadian dollar negatively impacted returns on markets outside of Canada, meaning that the outperformance of international markets relative to Canada would have been higher had the dollar not strengthened during the year. As mentioned in the past, we view a Canadian dollar in the 0.75 to 0.85 US$ range as reasonably fair value.

The S&P 500 closed out this year 71% above its pre-crisis peak from September 2007 and some 295% above the March 2009 lows.

Bond yields in Canada rose modestly in 2017 with the benchmark 10-year yield ending the year at 1.98%, up from 1.82% at the start of year. Despite dropping down close to 2% at one point during the year, rates on the 10-year Treasury in the U.S. were largely unchanged. U.S. 10-year Treasuries opened the year at 2.42% and ended the year at 2.46%. As we have noted in previous letters to clients, and touch on again below, bonds continue to look expensive to us both in relative and absolute terms.

Where do we go from here?

A 10 YEARS ON FROM THE GREAT FINANCIAL CRISIS

2018 will mark the 10 year anniversary of the Great Financial Crisis that saw, among other things, Canadian and Global Equity Markets drop close to 50%. Since bottoming in March 2009, equity markets have rebounded strongly and, despite some bumps along the way, continue to reach new highs on a regular basis. The benchmark S&P 500 index closed out this year 71% above its pre-crisis peak from September 2007 and some 295% above the March 2009 lows. This strong performance has led many commentators and prognosticators to warn that equity markets are overextended and a significant pullback is imminent. These predictions may turn out to be correct since, as we have pointed out in previous letters and will continue to remind clients, there is always the possibility of a pullback. However we encourage our clients not to get caught up in the myopia of short-term market predictions and to instead focus on the bigger picture as it relates to their portfolios.

IT IS ALWAYS EASY TO BE NEGATIVE

We believe it is important to remind clients that market predictions, especially negative ones, are more about selling books and attracting eyeballs (or clicks) than they are about providing sound investment advice. Sensationalizing everyday news is the simplest way for media outlets and authors to attract attention. Add to this the bias that humans have to being risk-averse and the result is that investors typically overemphasize the negative potential outcome versus the positive.

To demonstrate the never ending 'Wall of Worry' that equity markets must climb, below is a list of common (and very sensible sounding) reasons not to invest in the equity markets for each year going back to 2007. We have chosen to focus on the S&P 500 in US$ terms for ease of obtaining data.

When reading a headline the question is – 'how does this impact my long-term asset allocation?' and the answer is almost always that it doesn't.

Sensationalizing everyday news is the simplest way for media outlets and authors to attract attention.

Over the last 30+ years there have been very few occasions that it did not make sense for a long-term investor to be exposed to the equity markets.

Year	Reasons Not to Invest Highlighted in the Media	Reason to Invest	S&P 500 Annual Return	Cumulative Return since 2007	Annualized Return Since 2007
2007	House prices in the U.S. down close to 15% nationally leading to possible recession	Stocks offer reasonable long-term return potential relative to other assets	5.5%	5.5%	5.5%
2008	Lehman Brothers files for bankruptcy leading to global financial turmoil	"	-37.0%	-33.5%	-18.5%
2009	IMF calls recession the worst globally since the 1930s	"	26.5%	-15.9%	-5.6%
2010	Gold rises 30% on the year leading to increased fears of inflation	"	15.1%	-3.2%	-0.8%
2011	U.S. Federal credit rating downgraded by several rating agencies	"	2.1%	-1.2%	-0.2%
2012	Height of Eurozone debt crisis. Greek interest rates reach close to 30%	"	16.0%	14.6%	2.3%
2013	Consumer household debt levels reach pre-crisis levels	"	32.4%	51.8%	6.1%
2014	Oil price drops close to 50% increasing potential for recession in Canada	"	13.7%	72.5%	7.1%
2015	Fear of Chinese debt crisis. Chinese equity market down over 30%	"	1.4%	75.0%	6.4%
2016	U.S. debt to GDP ratio approaching post WWII high of 120%	"	12.0%	96.0%	7.0%
2017	Unexpected Trump election win increases global uncertainty	"	21.8%	138.7%	8.2%
2018	Markets continue reaching all-time highs. Valuation stretched relative to history	"	????	????	????

Source: Returns: RBC Capital Markets

This is by no means a comprehensive list. To name just a few more; there was widespread concern about the potential impact of the U.S. Debt Ceiling Debate (2011,2013), the Japanese Tsunami (2011), Russian annexation of Crimea (2014), an Ebola Outbreak (2015), Brexit (2016), North Korean Hydrogen bomb test (2016), alleged Russian Meddling in U.S. Presidential Election (2016). The list of potential concerns is essentially endless.

One often cited concern that we find particularly unhelpful is when we hear commentary about 'Global Political or Economic Uncertainty'. *There is always uncertainty and volatility somewhere in the world, this is not news.* The question an investor must ask themselves when reading a headline is – 'how does this impact my long-term asset allocation?' and the answer is almost always that it doesn't. Investors should evaluate and adjust their portfolio when their individual circumstances change, not because of a headline on a screen.

History has taught investors that most of the headlines we see in newspapers and online have little or no impact on the markets beyond the very short-term. This does not mean investors can blindly buy the stock market at all times and be confident of a positive outcome. It is critical to ensure an investor's asset allocation appropriately reflects the investor's near-term liquidity and withdrawal needs. There are also times that certain markets and sectors become overvalued and exposure to these areas should be reduced or avoided entirely. Two obvious examples are the Japanese Equity markets in the late 1980s and the Technology Sector of the S&P 500 in the early 2000s. However, these significant mispricings in the market are very much the exception and the fact is that over the last 30+ years there have been very few occasions that it did not make sense for a long-term investor to be exposed to the equity markets.

SO WHERE DO WE GO FROM HERE?

As many of our clients know, we believe the two most important factors that must be considered when constructing a portfolio are: 1) the investor's individual circumstances, specifically time horizons and liquidity needs, and 2) valuation. Comprehensive studies have shown valuation is the single best predictor of long-term investment returns. Reflecting on current market conditions, it is no secret valuations in the equity markets today are above historical averages across most metrics. Below is a high level summary of some common equity market valuation metrics.

Future returns from current valuations are likely to be lower than we have seen in the past

Valuation Measure (S&P 500)	Latest	25 Year Avg.
Price to Earnings (Forward)	18.2	16.0
CAPE (Shiller's Cyclically Adjusted P/E)	32.4	26.3
Dividend Yield	2.0%	2.0%
Price to Book	3.1	2.9
Price to Cash Flow	12.8	10.7

Source: JP Morgan Asset Management

This is not news; it is well known and well understood. The question is what to do about it and we believe there are a couple of key considerations.

Equities may be trading above average valuations relative to history, but bonds are trading at a premium to history as well.

Firstly, we would point out that historically returns on the U.S. equity markets going back over 100 years have averaged over 9.5% per year. So valuations that are above average relative to history do not suggest future returns are going to be negative, rather it suggests future returns from current valuations are likely to be lower than we have seen in the past. Current valuations suggest to us that future long-term returns in the equity markets are likely to be in the range of 7% to 8% per year going forward. This is ***not a prediction*** of what the market might deliver in any given year, as markets will remain volatile; this is simply a reasonable estimate of what a long-term investor might expect to earn on the equity markets on an annualized basis over time.

Despite the strong run in the markets our view remains that high-quality equities offers long-term investors the best opportunity of protecting and growing purchasing power.

Secondly, an investor must consider the return potential of other asset classes that are available. The typical comparison is the return potential between stocks and bonds, but in reality an investor can extend the analysis across any asset class. Investors can expect to earn a higher return from equities relative to bonds in exchange for living with the short-term volatility that is inherent in the equity markets. Looking at history, this return premium has been in the neighborhood of 5-7% over short-term government bonds. As shown in the tables below, current bond yields are well below their historical average so the expectation of a return of 7% to 8% from equities is very much in line with historical return premiums.

Equities may be trading above average valuations relative to history, but bonds are trading at a premium to history as well and, we would argue, carry a greater risk to purchasing power should interest rates or inflation rise.

	1900-2016 Avg.	Current
U.S. Treasury Bill (3-month)	3.55%	1.71%
U.S 10 year Treasury	4.71%	2.46%
Annualized return S&P 500	9.58%	???

Source: Jeremy Siegel/RBC Capital Markets

OUTLOOK AND STRATEGY

Be it equities, bond, real estate, private equity, hedge funds or fine art, the fact is that most asset classes that compete for an investor's capital are currently trading at premiums relative to historical averages. Be that as it may, it does not change the fundamental question all long-term investors must ask themselves, which is 'what asset class offers the highest likelihood of protecting and growing the purchasing power of my capital?' Despite the strong run in the markets post the 2008 Financial Crisis and the potential for more moderate returns going forward, our view remains that a diversified basket of high-quality equities offers long-term investors the best opportunity of meeting the fundamental goal of protecting and growing purchasing power.

As always, the primary caveat to maintaining significant exposure to the equity markets is that short-term liquidity needs should be set aside in an asset that is not subject to the volatility of the market. A long stretch without a material pullback in the equity markets, such as the one we are currently experiencing, can lead to investors becoming complacent about maintaining a sufficient

liquidity reserve. We encourage clients to review their short-term spending and liquidity needs and discuss any necessary changes with us.

We will be reaching out to you in the next few weeks to review your portfolio. However, if there have been any changes in your circumstances which would impact or change your investment objectives, please give us a call immediately to discuss.

New Portfolio Reporting Format

This is the first report Cypress has sent using our new reporting platform which the operations team has been working tirelessly to launch for many months. If clients have questions, concerns or any feedback about the new format please let us know. Our goal is to make these reports as relevant as possible for clients, while also meeting all the various compliance reporting requirements. Also, as part of the new reporting platform we are planning to launch online access to portfolios sometime in 2018. Many clients have suppressed hardcopies of their monthly statements from the custodians and have expressed a desire to do the same with their quarterly statements. The online client login will allow clients to access statements at their convenience and switch to ‘paperless’. Clients wishing to continue receiving a hardcopy of the quarterly report will be able to do so, but we expect many clients will opt for the electronic version only.

Sincerely,

CYPRESS CAPITAL MANAGEMENT LTD.