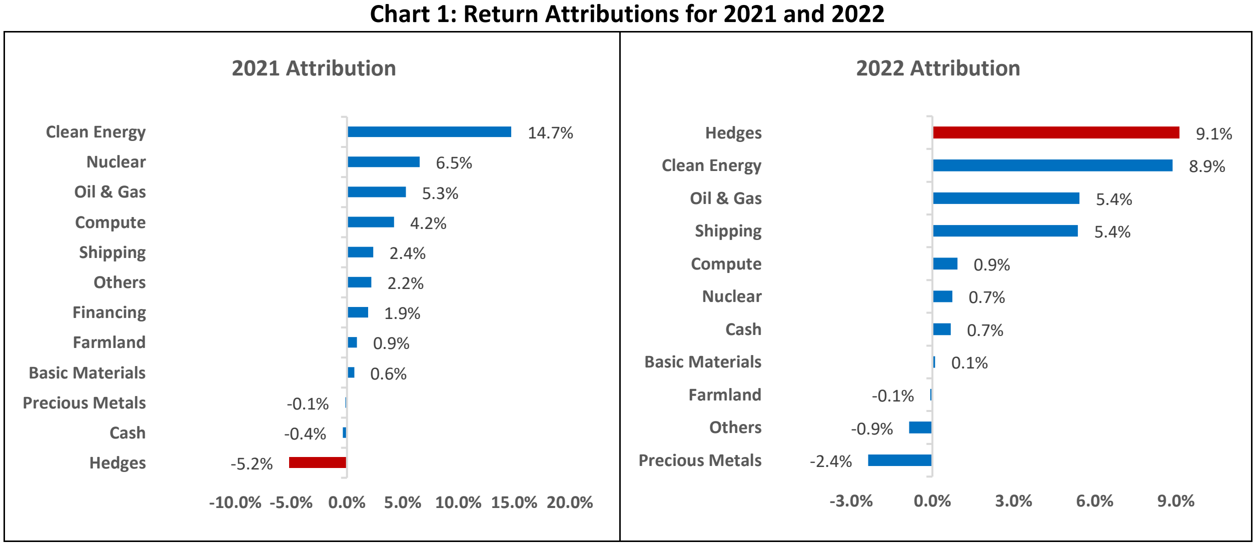
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019			0.1%	0.3%	4.3%	-4.2%	0.1%	-0.1%	0.9%	-4.1%	7.5%	6.0%	10.5%
2020	-6.2%	-2.0%	2.5%	12.4%	3.6%	-6.6%	19.6%	12.1%	-3.0%	-7.1%	2.1%	11.9%	41.6%
2021	1.1%	3.5%	-0.5%	6.3%	19.5%	-3.2%	4.0%	-5.2%	6.0%	9.9%	-8.1%	-1.4%	33.0%
2022	1.5%	11.5%	5.7%	3.7%	1.6%	-5.9%	-1.9%	1.0%	0.2%	-1.4%	4.9%	4.6%	27.5%
2023	-1%*												-1%*

- **The Cypress Fund returned 27.5% in 2022 with a 1.8 Sharpe and minimal equity correlation.**
- **Hedges contributed the largest share (+9.1%), reflecting our cautious stance throughout the year. Clean Energy, Oil & Gas and Shipping also made substantial gains.**
- **Rising, persistent inflation was the story of 2022. This resulted in sharply higher interest rates, which dragged down the performance of all risk assets.**
- **Looking ahead, we expect interest rates to continue playing a critical role in driving asset class returns as it impacts companies' cost of capital and discount rates used in valuations.**
- **We like short duration government bonds as real rates are at the highest levels in over a decade, inflation is falling and growth is slowing.**
- **However, we remain cautious towards equities and corporate bonds given the potential of risk premiums/spreads widening. It does not seem like risk premiums/spreads adequately account for the possibility of earnings declines and spike in corporate defaults.**
- **At Cypress, we maintain our cautious stance towards risk, while staying invested in real assets to take advantage of the capital cycle.**

Dear investors,

Chart 1: Return Attributions for 2021 and 2022



In 2022, the Cypress Fund returned +27.5% net of fees, with a Sharpe ratio of 1.8 and effectively zero correlation to equities (-1% vs S&P 500). The themes that did the heavy lifting last year included Clean Energy (+8.9%) and Oil & Gas (+5.4%), both of which were also leaders in 2021. Shipping (+5.4%) also did well, as crude tanker charter rates surged, in part due to the Ukraine war. Of particular note, portfolio

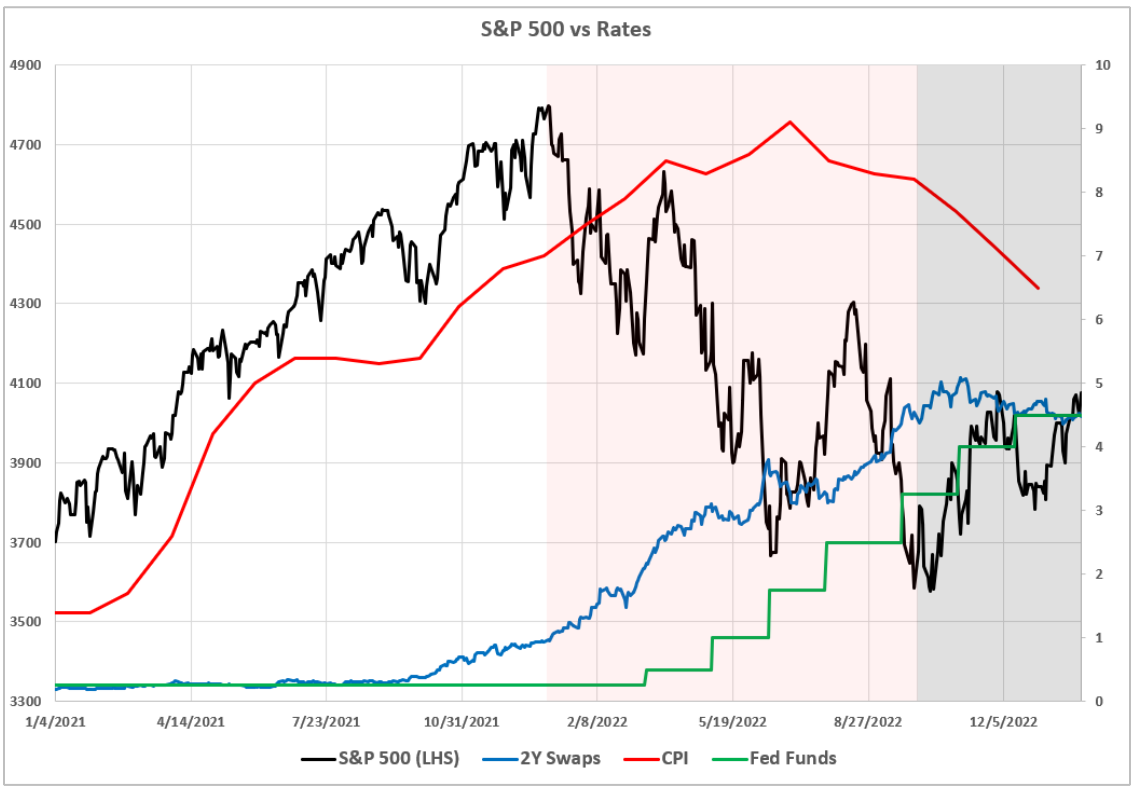
* January 2023 based on preliminary estimates

hedges, instead of being a detractor to performance like in 2021, contributed the biggest share (+9.1%), validating our cautious approach towards risk-taking throughout the year.

2022 Summary: Rising, Persistent Inflation -> Interest Rates Higher -> Equities Lower

2022 was a year dominated by macro developments. While there were many events last year, some political and some economic, that one can point to as the reason for poor stock and bond returns, it is undeniable that the driving force was inflation. Inflation, which started climbing in 2021 (red line), proved to be less transitory than many hoped. Interest rates markets first took notice – two-year rates started rising as early as 4Q21 (blue line). Shortly thereafter, the Fed began the first in a series of hikes that brought overnight rates from 0.25% to 4.5% (green line). The sharp rise in the risk-free rate across the entire curve meant that all risk assets needed to be re-priced lower. The outcome – the worst year ever for bonds and the third worst for stocks since the 1970s.

Chart 2: Inflation as Driver of Financial Markets in Three Phases



Phase 1 (White): Rates Low, Equities Rise
Phase 2 (Pink): Rates Spike Higher, Equities Fall
Phase 3 (Grey): Rates High but Rangebound, Equities Rebound

With the benefit of hindsight, we can observe three fairly distinct phases in financial markets over the preceding two years:

In the first phase (white region: Jan-Dec 2021), equities rose as inflation picked up. Initially, rising inflation was welcomed as a sign of an economy recovering after Covid; when inflation hit levels that were no longer desirable, it was rationalized as temporary. **Interest rates started creeping higher** by the end of this phase, but equities performed well as investors remained sanguine.

In the second (pink region: Jan-Sep 2022), equities got pummeled as surging inflation showed no signs of abating. **Interest rates rose sharply** during this phase in response to fears that inflation could get entrenched. 2-year rates rose nearly five-fold from under 1%, coinciding with a newly hawkish Fed that hiked rates aggressively. With the higher risk-free rate, all asset classes need to be repriced. In just six months, the S&P 500 gave back all of its gains from 2021, in the worst 1H for stocks in four decades.

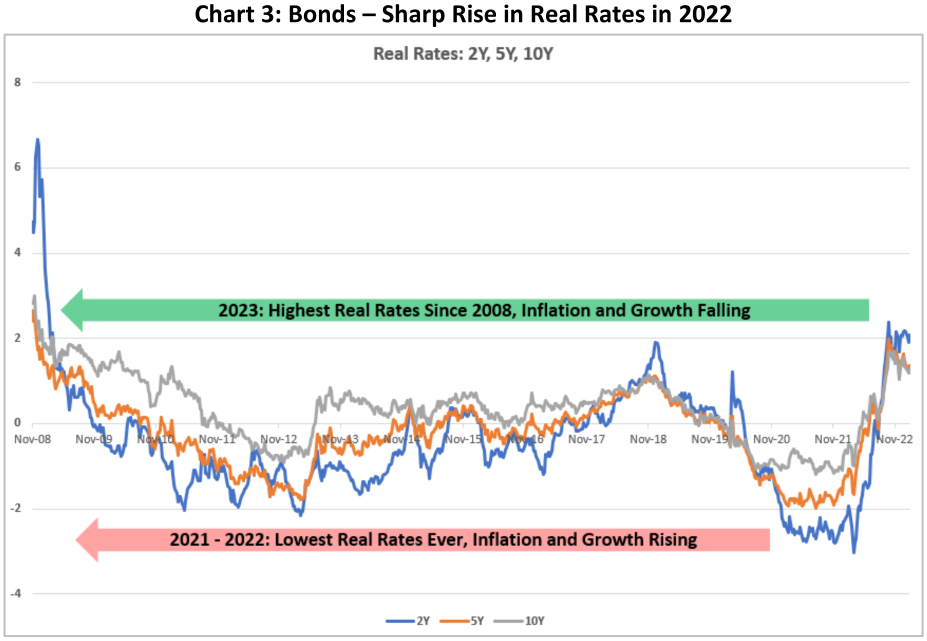
In the third and current phase (grey region: Oct 2022 onwards), equities staged a rebound as inflation began falling from its peak. Again, this was first telegraphed by the interest rate markets. In 4Q22, **rates finally stopped their relentless rise**, trading in rangebound fashion. Despite a Fed that continued to speak and act hawkish, investors interpreted this as light at the end of the tunnel, fueling the nearly 20% trough-to-current rally in the S&P 500.

There is no doubt that the interest rates market has been in the driver's seat in the preceding two years; it is likely that it will still play a prominent role driving investor behaviour going forward. As such, we will devote the rest of this letter to what we see in the rates market, and what these imply for risk-taking in the year ahead.

US Government Bonds Have Not Been This Attractive Since 2008

After the worst year ever for bonds in 2022, we are in the camp that short duration US government are a reasonable investment this year. Real rates are at the highest levels since 2008, inflation seems to have peaked (for now) and economic growth appears to be slowing. We prefer short duration bonds (<2 years) as both nominal and real rates are highest in this part of the curve; and should inflation/growth turn out to be higher than expected, the downside is limited.

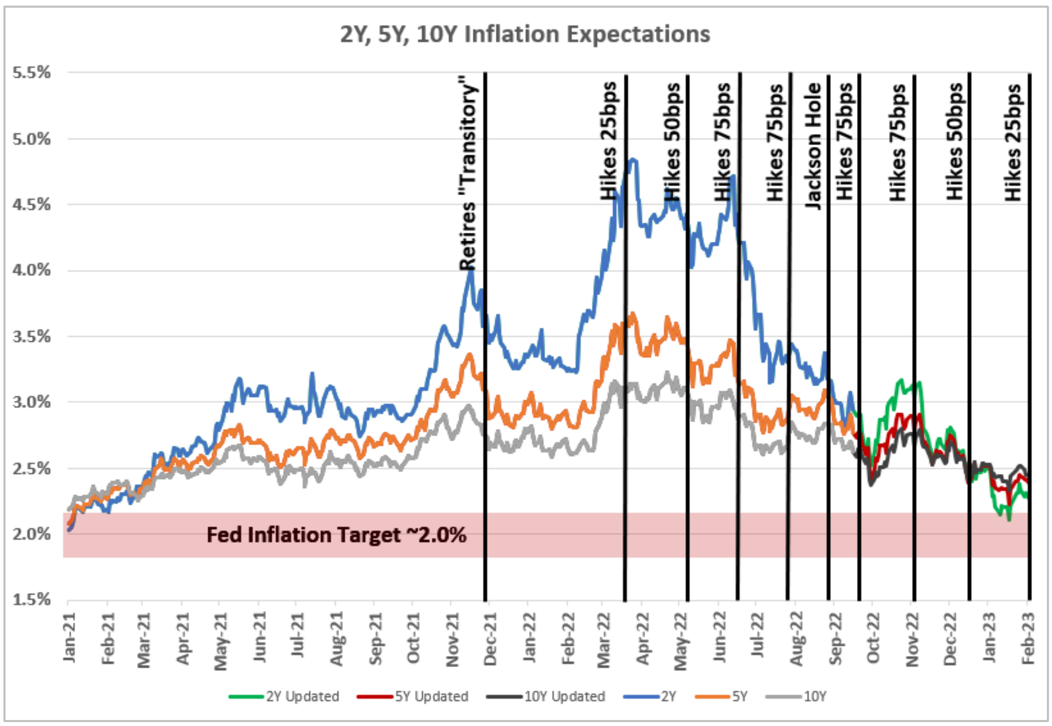
Chart 3: Bonds – Sharp Rise in Real Rates in 2022



In retrospect, perhaps it should not come as a surprise that bonds did poorly in 2022. At one point, 2Y bonds traded at a level that implied -3% annualized real return. To exacerbate this, inflation was high and rising – actual losses could well be even greater than that. To quote Jim Grant, instead of giving risk-free returns, bonds offered *return-free risk*.

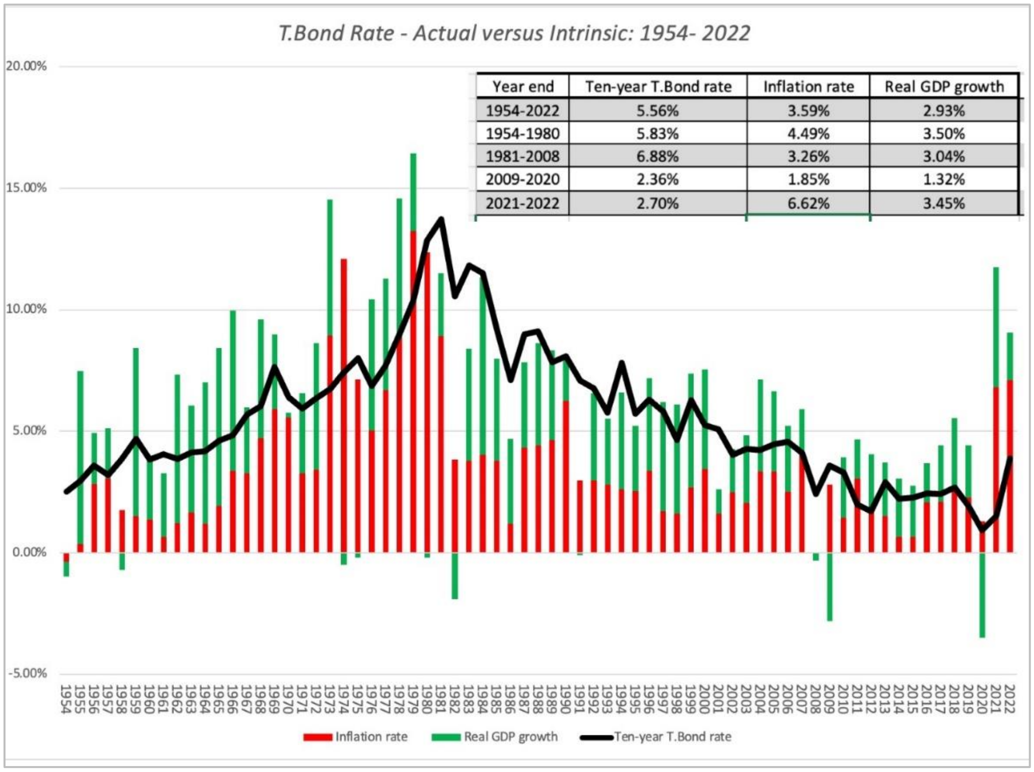
The dynamic has been completely reversed. Today, government bonds are offering the highest real returns since 2008 even as inflation subsides. The former should drive demand for bonds by itself; the latter offers an additional kicker. We can see from Chart 4 that inflation expectations have subsided to the Fed's target since we last wrote about it in our 2022 September Investor Letter. Unless inflation expectations spike again, the Fed is near the tail end of the hiking cycle, which is positive for bonds.

Chart 4: Fed Has Successfully Contained Inflation Expectations



Finally, it is worth reiterating that interest rates are ultimately driven by a combination of growth and inflation. Over the long term, rates are very highly correlated to these metrics (Chart 5). Since we first wrote about recession risk last July, many of the metrics we pay attention to (consumer sentiment, housing, business owners outlook) have continued to deteriorate. Slowing and potentially contracting growth should act as gravity that should pull rates lower.

Chart 5: 10Y Highly Correlated to Growth and Inflation



Source: [Aswath Damodaran]

High Interest Rates: Good for the Lender, Bad for the Borrower

In the previous section, we explained our positive outlook for short duration government bonds. As rates rose so much last year, bonds now offer the highest real returns in over a decade amidst an environment of falling inflation and economic growth.

But while this may be welcomed by lenders, the rise in interest rates is unambiguously bad for borrowers. Just ask any homeowner who has a floating-rate mortgage in a rising rate environment. Some of the negative effects of rising interest rates include:

- Slowing the growth of the economy by making it more expensive for consumers to buy on credit and companies to invest in facilities, equipment and inventory
- Increasing businesses' cost of capital and hence reducing their profitability
- Decreasing the fair value of assets as discount rates are adjusted higher
- Creating negative-wealth effect by reducing asset prices; both consumers and companies feel poorer and thus less willing to spend
- Lowering the prices investors are willing to pay for investments in response to a higher discount rate

It would therefore not surprise us if the economy and its constituent companies are in for a rougher ride this year as borrowers adjust to a higher cost of capital. According to estimates by NYU Professor

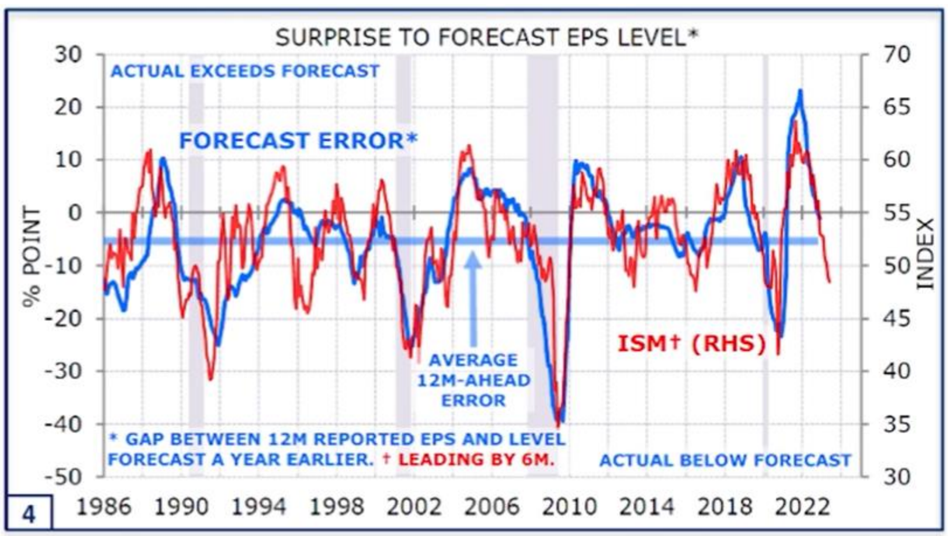
Aswath Damodaran, the median cost of capital for US companies rose more than 60% from 5.77% at the start of 2022 to 9.63% at the start of 2023. Globally, cost of capital also rose from 6.33% in 2022 to 10.6% in 2023. Given this, we are somewhat puzzled by the recent enthusiasm in both equity and corporate bond markets. In fact, our base case is that this rise in capital cost will translate into earning declines and rising corporate default rates with a lag, neither of which are priced in today.

Negative Equities: Corporate Earnings Will Fall, Equity Risk Premium Will Rise

For all the talk of recession, the market seems to already be looking through to the eventual recovery. Leading economic indicators suggest that we may need to adjust earnings estimates lower by another 15-20%, which historically has been associated with additional 20-30% drawdown in equities. If earnings get cut, it is also likely that equity risk premium rises, which also points towards lower stock prices.

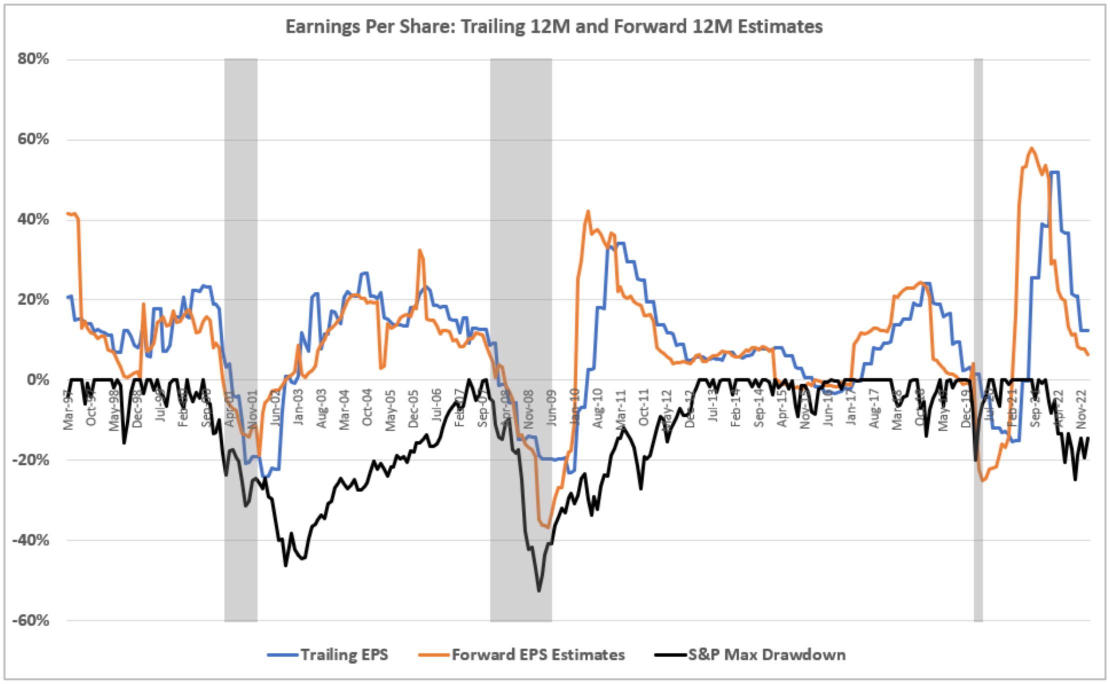
The ISM Purchasing Manager's Index has an excellent track record in predicting forecast errors in earnings estimates. The most recent PMI weakened further to 47.4, a figure that would be consistent with a 15% cut in EPS (earnings per share) estimates.

Chart 6: ISM PMI Predicts Steep Cuts in EPS



We get a similar message when we consider trailing EPS and forward earnings estimates for the S&P 500. In the three most recent recessions (2000 tech bust, 2008 GFC, 2020 Covid), both actual and forecasted earnings suffered 20% year-on-year cuts before the economy started growing again. Today, despite the chorus of voices calling for a recession, both trailing and forward EPS are still positive year-on-year. Chillingly, if we are indeed headed into a recession, history suggests additional 20-30% downside from here in equities.

Chart 7: Recessions (Grey Bar) Meant 20% EPS Cuts and 40-50% Equity Drawdowns



With exception of 2020 Covid episode, recent economic contractions coincided with 40-50% drawdowns in equities. That would imply additional 20-30% downside in equities from current levels.

Another helpful, if somewhat theoretical, approach towards stock valuations is to consider the equity risk premium (ERP) implied at current prices. Equities are more risky than government bonds, so it is reasonable for equity investors to demand an additional return on top of the risk-free rate – this is the equity risk premium. The lower it is (ie investors accept a lower return), the higher are stock prices, and vice versa. Equity valuations today imply an ERP of around 4.6%; on the low side against a range of 4.2-6.4% since the GFC. We thus see risk that the ERP can widen (especially if earnings are cut), and correspondingly more downside for stocks.

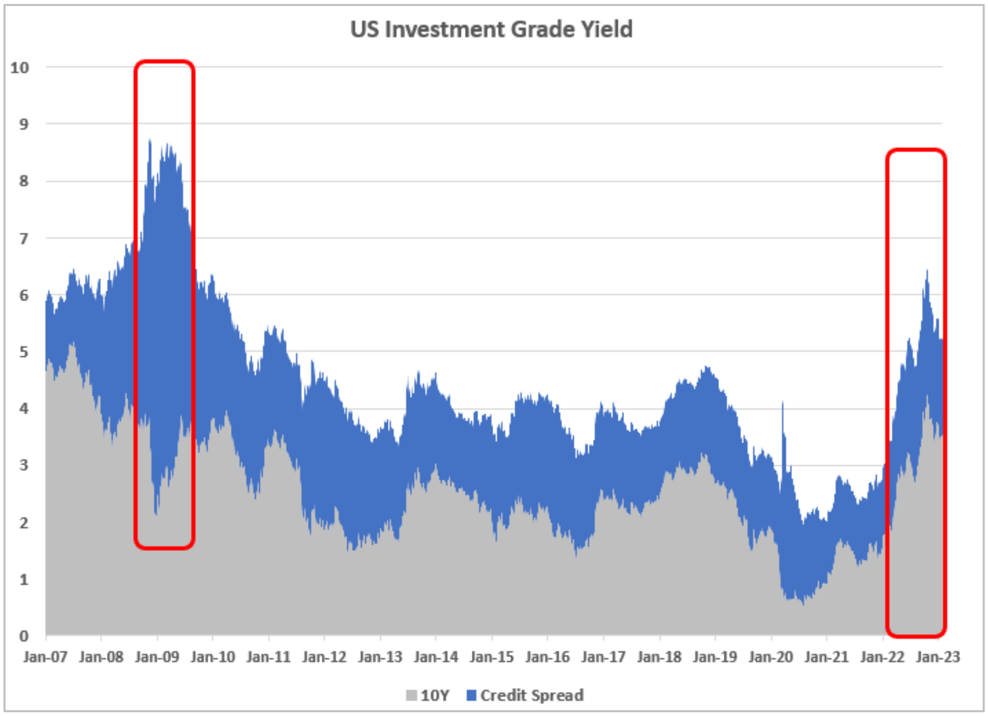
An alternative analysis offers a similar sobering conclusion, even assuming ERP stays unchanged. In a simple scenario analysis, if inflation subsides and we avoid a recession, there may be another 5% upside in stocks. On the other hand, should inflation stay elevated while the economy contracts, the downside could be 15%. Given this, it is hard for us to get too excited about stocks.

Scenarios	No Recession	Recession
Inflation Subsides	**S&P: 4360 (+5%)** *Assumptions:* *10Y Bonds Decline to 2%* *Earnings Estimates Unchanged*	**S&P: 3920 (-5%)** *Assumptions:* *10Y Bonds Decline to 2%* *Earnings Estimates Cut 10%*
Inflation Stays High	**S&P: 3930 (-5%)** *Assumptions:* *10Y Bonds Rise to 5%* *Earnings Estimates Unchanged*	**S&P: 3540 (-15%)** *Assumptions:* *10Y Bonds Rise to 5%* *Earnings Estimates Cut 10%*

Negative Corporate Bonds: Defaults Will Rise from Cycle Lows

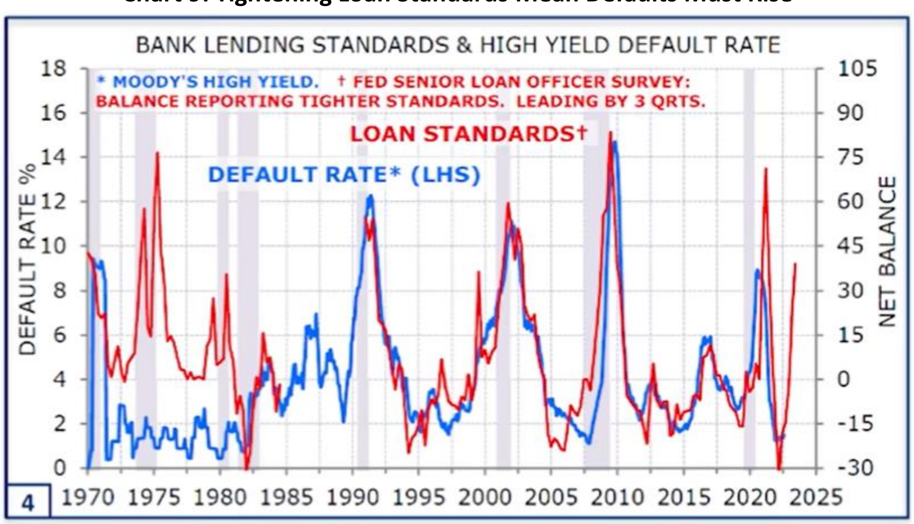
Nor do we find corporate bonds that attractive despite the large rise in yields last year (Chart 8). Yields doubled over the course of the year to nearly 6% but this was driven for the most part by the rise in Treasuries. Credit spreads barely widened, showing that investors are still upbeat about default rates.

Chart 8: Credit Spreads (Blue) Can Explode in a Recession; So Far They Have Barely Budged



It is a near certainty that default rates, currently at cycle lows, will rise as the economy slows (Chart 9). Inevitably, credit spreads will widen as this happens. Thus, it is still too early to be buying corporate credit today.

Chart 9: Tightening Loan Standards Mean Defaults Must Rise



Cypress: Taking Advantage of the Capital Cycle and Staying Invested in Real Assets

In the short run, the market is a voting machine, but in the long run, it is a weighing machine.
– Warren Buffett, 1987 Berkshire Letter

Hedge funds charge high fees, and it is our responsibility to be aware of the forces at work in both the short and long run. So far in this letter we have only touched upon the short run because macro factors dominated in the past year and we expect this to still matter a lot this year. As we quipped in our [2021 Year End Investor Letter]:

You can choose not to care about macro, but you can't choose to be unaffected by it.

That said, we think it is important to bring the discussion back to the core of the Cypress strategy and why we are invested in real assets. After all, this is our true destination; the short-term swings are the storms and turbulences we must overcome on our way there.

In essence, the Cypress Fund invests in Real Assets because we believe this asset class will deliver extraordinary returns to our investors in the years ahead. After years of dis-interest, real assets are showing up again on investors' radars as the asset class to own when inflation is rising. More importantly, after a decade of capex underinvestment, real assets are exactly at the point in the [capital cycle] (Chart 11) where returns are high and rising because growing demand cannot be met with new supply, resulting in persistently high prices. This is happening amidst longer term trends (energy transition, resource nationalism and onshoring of supply chains) and shorter term exogenous shocks (Covid, Ukraine war) which will fuel demand for the most basic of necessities – food, energy, raw materials and precious metals, exactly the types of real assets that Cypress is invested in.

Chart 10: Prior Underinvestment Will Drive Long Term Outperformance in Resource Sector

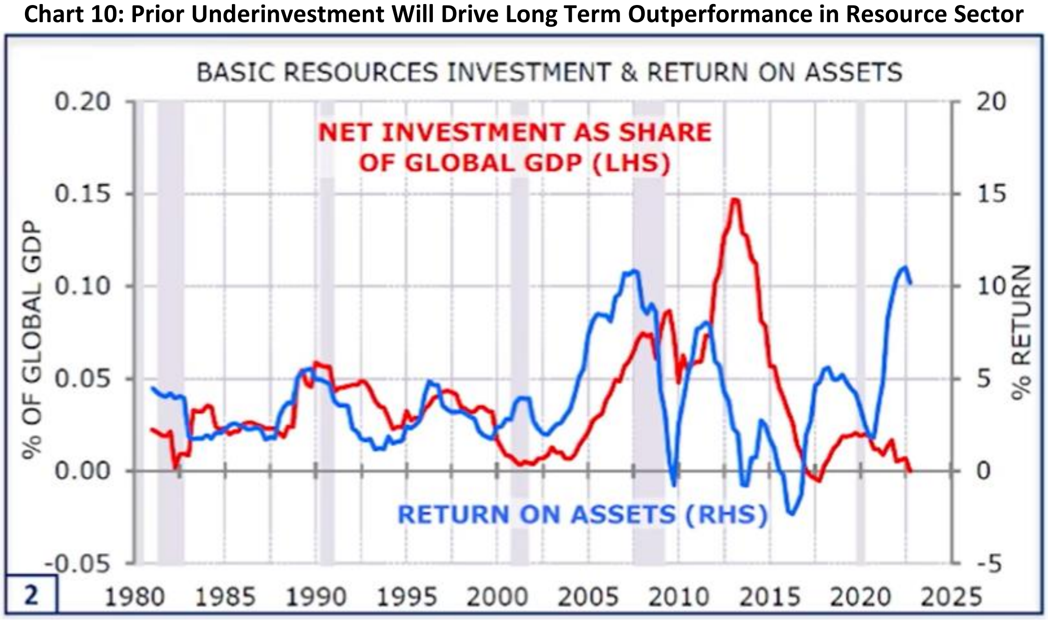
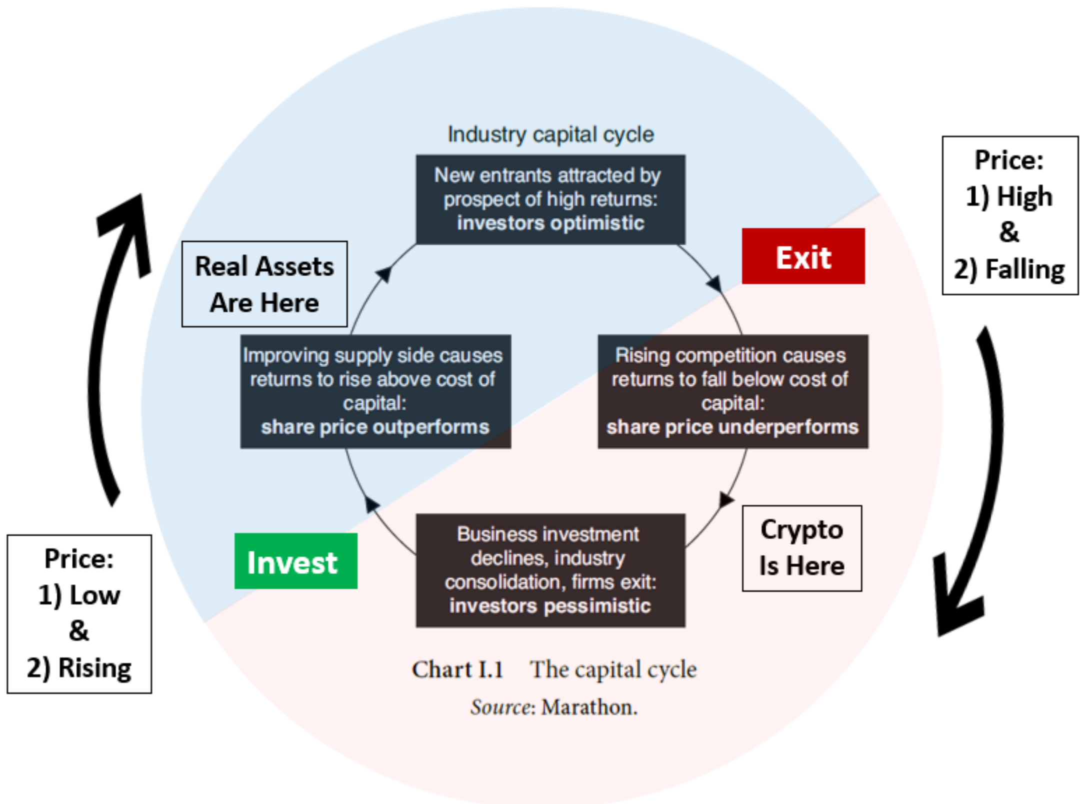


Chart 11: Real Assets In the Right Part of the Capital Cycle



Conclusion

In our last two annual letters, we provided road maps for the year ahead. In our 2020 Letter, we quoted the legendary Bill Miller, who offered a bullish outlook for 2021 which we agreed with. In our 2021 Letter, we cast our vote with Jeremy Grantham, who predicted a bursting of the equity bubble in 2022. This year, we draw inspiration from Oaktree's Howard Marks. Excerpting from his latest memo in 2022, Sea Change:

> *…the buyers who've driven the S&P 500's recent 10% rally from the October low have been motivated by their beliefs that (a) inflation is easing, (b) the Fed will soon pivot from restrictive policy back toward stimulative, (c) interest rates will return to lower levels, (d) a recession will be averted, or it will be modest and brief, and (e) the economy and markets will return to halcyon days…*
>
> *…we never know where we're going, but we ought to know where we are. The bottom line for me is that, in many ways, conditions at this moment are overwhelmingly different from – and mostly less favorable than – those of the post-GFC climate…*
>
> *We've gone from the low-return world of 2009-21 to a full-return world, and it may become more so in the near term. Investors can now potentially get solid returns from credit instruments,*

meaning they no longer have to rely as heavily on riskier investments to achieve their overall return targets. Lenders and bargain hunters face much better prospects in this changed environment than they did in 2009-21. And importantly, if you grant that the environment is and may continue to be very different from what it was over the last 13 years – and most of the last 40 years – it should follow that the investment strategies that worked best over those periods may not be the ones that outperform in the years ahead.

	2009 to 2021	**Today**
Fed behavior	Highly stimulative	Tightening
Inflation	Dormant	40-year high
Economic outlook	Positive	Recession likely
Likelihood of distress	Minimal	Rising
Mood	Optimistic	Guarded
Buyers	Eager	Hesitant
Holders	Complacent	Uncertain
Key worry	FOMO	Investment losses
Risk aversion	Absent	Rising
Credit window	Wide open	Constricted
Financing	Plentiful	Scarce
Interest rates	Lowest ever	More normal
Yield spreads	Modest	Normal
Prospective returns	Lowest ever	More than ample

Regular readers of Howard Marks will know that he seldom takes a view on markets, so this really is a striking departure from his usual equivocal style. Likewise, we think that the environment has changed. Strategies that worked well may not be the ones that outperform going forward; bargain hunters (as we are) face much better prospects in this new paradigm. And the most compelling asset class we see in this new paradigm, and therefore pursue, is in real assets.

Last but not least, thank you for your support over the years. Best wishes in the new year, thank you for reading and we look forward to connecting soon.

Sincerely,

Yongchuan Pan
6 February 2023