JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 25• Summer 2004**

> *"The investment advisers who come to the Berkshire meeting are not a cross-section—we get the cream of the crop."*
> *Charles Munger—Vice Chairman*

The second quarter was characterized by investors becoming more discriminating, leading to a focus on higher quality, large capitalization companies. Companies with dividends out-performed non-dividend payers, companies with the highest "free cash flow" yields out-performed those with the lowest "free cash flow" yields and low-beta names out-performed their high-beta counter-parts. While this was a complete about-face from last year's rally, we view this as a healthy change for the markets. The chart below shows that in the quarter just ended, the larger stocks led the way as the S&P 500 index and Dow Jones Industrial Average were up 1.75% and 1.19% respectively. The small and mid-cap indexes cooled off somewhat from the first quarter of the year. This was evidenced by the returns on the S&P Mid-Cap index and Russell 2000 index which advanced by .97% and .47% respectively. This quarter was the first in the last five quarters that large-capitalization stocks outperformed the small-cap issues. According to Lipper Analytical, the average domestic equity fund advanced by just .84% for the quarter just ended.

Index	2nd Qtr 2004	6 mos. ended 6/30/04
DJIA	**1.19%**	**.87%**
S&P 500	**1.75%**	**3.58%**
S&P Mid Cap	**.97%**	**6.08%**
Russell 1000/Growth	**1.94%**	**2.74%**
Russell 1000/Value	**.88%**	**3.94%**
Russell 2000	**.47%**	**6.76%**
NASDAQ Comp.	**2.79%**	**2.43%**

In January of this year, we stated that we thought the domestic equity markets would trend higher in 2004, with the bulk of the gains coming in the first half of the year. We expected easy earnings comparisons in the first half and thought it was unlikely that the Federal Reserve would take any drastic actions in an election year. We also observed in January that we thought the second half of the year would be more frustrating for investors, as the prospects of higher interest rates and tougher earnings comparisons became more likely. Our thinking has not changed much since earlier in the year. The economy is performing well, however, interest rate fears and uncertainty over the coming election, will likely result in only "mediocre" returns for the market averages over the second-half of the year.

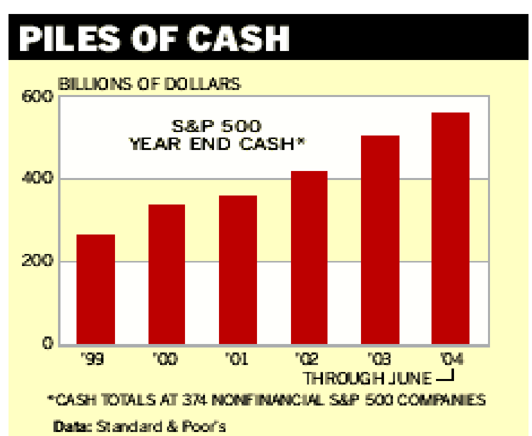
Since we are at the half-way point in 2004, we thought it might be a good time to look at some of the factors that are likely to influence stock and bond prices in the second half.

Economy

The economy has been very strong. With less economic stimulus, the economy will not likely maintain its torrid pace, but the general economic picture still looks solid. The business sector is in excellent shape with exceptionally strong cash flow and improved balance sheets. This bodes well for job creation, capital investment, and the rebuilding of inventory levels. There has been continued good news on productivity, which has rebounded to a very high level. This is important because it is one key factor supporting economic growth with moderate inflation. The big area of concern has been the labor market but that too is showing clear signs of improvement. Wage growth is also improving, but off of a very sub-par level. Consumer spending has been healthy, although recently it has exhibited some weakening trends.

Corporate Profits

Over the past few years corporations had to deal with a series of events: recession, terrorist attacks, and financial scandals. In light of these factors, many companies slashed expenditures in an effort to strengthen their balance sheets and boost cash reserves. A rebounding economy, coupled with continued budgetary discipline has been generating a huge surge in earnings. Collective earnings for the S&P 500 reached a record $481.7 billion in the first quarter of 2004 and analysts expect the record to be eclipsed when the second quarter numbers are compiled. Cash profit margins are at levels not seen in decades, and the level of profits as a percentage of GDP, at over 10%, is high by historical measures. However, corporations have been reluctant to spend, despite their tremendous new found wealth. Although capital spending is rising, it has lagged behind the surging cash flows, which hasn't happened since the mid 70's. All of this has created an enormous cash hoard for corporate America.



In fact, according to "*Business Week*", 24 of the 374 industrial companies in the S&P 500 currently have over $5 billion in cash on hand. What will these companies do with all this cash? They can deploy cash to fuel growth by upping capital spending and hiring new workers or they can acquire other companies. Additionally, they can return some of the cash to investors through higher dividends (remember the 15% rate on dividends) or they can step up share repurchases. Any of the above alternatives would likely be viewed as a positive in the equity markets.

Interest Rates and Inflation

Inflation is picking up and rates have backed up in the bond market. The 10-year Treasury note's yield, which is used to set interest rates on home mortgages, started the quarter at 3.84%, and at one point during the past quarter rose to 4.90%, the highest level since June 2002. Merrill Lynch's U. S. Treasury Master Index fell 3.7% during the second quarter, its biggest quarterly decline since the third quarter of 1980. The rise in rates has also contributed to nervousness in the stock market. However, it is important to understand that rates are rising because the economy is getting stronger, and this is reflected by rising profits. In addition, rates are rising from such a depressed level that it is unlikely that the initial rise will hurt the stock market in a lasting way—especially since bond markets have already moved lower in anticipation of a short-term rate increase.

Even the pessimists don't expect a huge spike in inflation, but it is accelerating. Core consumer prices increased at a 2.9% annual rate in the first five months of this year, compared with 1.3% in the same period last year. Including food and energy, prices rose at a 5.1% clip versus 2.3% last year. If inflation is sustained too long at a level much higher than 3%, the corresponding higher interest rates could adversely impact stock prices. Higher rates not only raise the discount rate for valuing the market, it also leads to higher borrowing costs for corporations. The arguments against higher inflation are high productivity, and excess labor and production capacity. The primary arguments for higher inflation are that monetary and fiscal policy have been extremely stimulative over the past few years. Apparently the Federal Reserve Board has become somewhat concerned about the inflationary pressures, as they raised rates by a quarter of one percent on June 30th. The Fed last raised the funds rate in May 2000, to 6.5%, to cool an economic boom fueled by a bubble in stocks and technology investment spending. Over the next three years it cut the rate thirteen times to 1%, the lowest since 1958.

The Dollar

The dollar has been in a gradual decline for some time now. This has the effect of making U. S. exports less expensive to foreign buyers, with positive implications for corporate earnings (multi-nationals). However, a weakening currency can have a negative impact on the financial markets in that it reduces the returns/performance for foreign investors. In the event that this results in foreigners pulling money out of the U. S markets, it can cause a decline in stock prices and a rise in interest rates. While this scenario has not materialized, it is worth considering especially in light of the very high current-account deficit. Any steep decline could have long lasting implications on the economy of the U. S. and its major trading partners.

Valuations

As of June 30, 2004, the 12 month forward price/earnings ratio for the S&P 500 index was approximately 16.5 times. This is near its historical mean valuation of approximately 16 times earnings. It should be noted that price/earnings ratios have been above that level for most of the time since 1995. On numerous occasions we have mentioned the Fed Model which is essentially a dividend discount model used by the Fed to help determine if stocks are over or under-valued. The model essentially compares the earnings yield (forward earnings) for the S&P 500 to the yield on the 10 year Treasury note. The model currently shows stocks to be approximately 20% undervalued relative to bonds. We should point out, however, that the model is not perfect and is dependent on the accuracy of the earnings estimates. Additionally, any rise in interest rates would result in a less bullish reading from the model.

Conclusions

In summary, we currently have a tug-of-war between an exceptionally strong economy (and profits) and rising interest rates. While stocks appear reasonably valued at the current time, any significant rises in interest rates would create a head-wind for corporate earnings and stocks in general. The U. S. trade deficit has weakened the "dollar"; any further weakness would likely create another negative factor for domestic stocks and bonds. At the present time, the positives and negatives seem to offset one another, leading us to conclude that the markets are likely to be somewhat range-bound over the coming months. So while the indexes are unlikely to make any significant headway, we believe that pockets of opportunity do exist and that it will be a "stock picker's market" going forward. Jason Trennert of ISI Research recently predicted that in a stable, low return environment (such as we are now in), "…active management will be back in vogue…since 1971, nearly 50% of general equity funds were able to beat the index when returns were below average. Only 26% were able to beat the index when returns were above average." We agree with Mr. Trennert and feel that our "multi-cap" value strategy will serve our clients well over the coming months.

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