JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook — **Volume 1, Issue 35• Spring 2007**

> *"A company with more cash than it needs more often than not uses it in such a way as to reverse the problem."*
>
> *Malcolm Forbes*

After a difficult February, stocks rebounded in March, resulting in positive returns for most of the major indexes for the first quarter. As the chart below shows, the S&P 500 Index managed a return of .70% for the quarter while the Dow Jones Industrials declined by -.19%. Small and mid cap stocks were the strongest sectors of the market as evidenced by the Russell 2000 gain of 1.95% and the S&P Mid Cap index return of 5.80%. Growth and value styles essentially generated similar returns for the quarter.

Index	1st Quarter 2007
DJIA	-.19%
S&P 500	.70%
S&P Mid Cap	5.80%
Russell 1000/Growth	1.19%
Russell 1000/Value	1.24%
Russell 2000	1.95%
NASDAQ Comp.	.26%

While the chart does not reflect it, the quarter was extremely challenging and volatility returned in a big way after a seven month hiatus. A huge drop in the Chinese stock market in late February led to a one day decline of 3.5% in the U. S. stock market. In our opinion, the correction was long overdue. In our "*Investment Outlook—Winter 2007*", we stated, "Investor sentiment has become too optimistic, increasing the odds of a meaningful correction." The chart below shows that the recent correction was somewhat shorter in duration and percentage terms than other corrections over the past five years. Only time will tell if this corrective phase has fully run its course.

S&P 500 Bull Market Corrections Since 2002

Start	End	Duration (in months)	% Change
3/5/2004	8/12/2004	5.1	-8.1%
3/7/2005	4/20/2005	1.5	-7.2%
8/3/2005	10/13/2005	2.1	-5.5%
5/5/2006	6/13/2006	1.3	-7.7%
2/20/2007	3/5/2007*	.4	-5.9%
Average		2.5	-7.1%

**low point of current cycle—Source: Bank Credit Analyst*

Bernanke Trying out the Greenspan Put?

As we discussed in our last *Investment Outlook* in mid January, we felt that any market correction would likely be accompanied by an accommodative Federal Reserve which would provide a lift to both stocks and bonds. While Bernanke did not lower rates in March, he removed the language "tightening bias" and reference to "additional firming" and instead stated that "future policy adjustments will depend upon the evolution of the outlook for both inflation and economic growth". This suggests that the Fed may be increasingly concerned about the melt-down in the sub-prime mortgage market. The fact that the Fed removed its tightening bias, despite noting that "recent readings on core inflation have been somewhat elevated" would seem to indicate that the "Greenspan Put" or should we say the "Bernanke Put" is alive and well. (Put options are essentially option contracts used by investors to minimize downside risk). As we have discussed before, the "Greenspan Put" refers to our last Fed Chairman Alan Greenspan, who was notorious for solving market crises by lowering interest rates. The "Greenspan Put" term was coined by the Wall Street crowd with the idea being that Greenspan's easy money policies would always be there to help markets stabilize—and with Greenspan at the helm, your risk was always limited. While people can agree or disagree with whether some of Greenspan's rate cuts were justified or not, it is our opinion that he over-reacted to short term dislocations in the financial markets. He essentially prevented an economic downturn which is healthy and essential in cleansing excesses in a capitalist economy. While on the surface this may seem good, the flood of liquidity has led to an unprecedented period of excessive risk taking. In fact, many believe Greenspan's policies were largely responsible for the bubble which occurred in the NASDAQ, and more recently, in real estate. It is too early to tell exactly what Bernanke's intentions are—time will tell. We believe the new Fed approach will likely cause the yield curve to return to normal (currently inverted), with short rates falling below long term rates. It will also likely result in a falling U. S dollar as investors switch into other higher yielding currencies.

Credit Cycle

The growth in credit has been well publicized over the past few years. According to the Bank Credit Analyst, credit growth has far outpaced Gross Domestic Product in recent years, leading to all time highs in the consumer debt to income ratio. Approximately 70% of the growth in debt (non-federal) was in residential mortgages, as rising home prices encouraged home equity extraction. The recent housing downturn has dealt a serious blow to credit growth in recent months. The last time the credit cycle retrenched was in the recessionary days of the early 1990s. Ironically, throughout the 2000-2001 recession, credit growth actually expanded, essentially due to easy monetary policy by the Fed. In the typical economic cycle, consumer credit contracts during recessionary times, as borrowers attempt to re-liquefy their balance sheets. The recent problems in the sub-prime area have effectively cut-off the supply of mortgage financing to low income borrowers. The sub-prime sector represented about 20% of last years mortgage originations and the weakness here will likely put further downward pressure on the housing sector.

The banking system is currently in a very strong financial position which should provide a cushion with regards to possible mortgage delinquencies. However, there are some serious headwinds. According to the Bank Credit Analyst, approximately 44% of bank assets were currently related to real estate, double the level of twenty years ago. Delinquency rates for residential and commercial real estate bank loans moved up in the second half of 2006, but remain low by historical measures. The long stretch of prosperity in the banking sector has resulted in loan loss reserves at a twenty year low relative to total loans. This would imply that any jump in bad loans would require higher loan loss provisions and charge offs, resulting in lower profits. While we believe the financial strength of the banks will enable them to weather the storm, we have maintained a significant underweight position in the financial sector. Financials currently make up 21.6% of the S&P 500 index and 35% of the Russell 1000 Value index. In the first quarter of 2007, financials declined by approximately 2.8%.

Earnings

In the next few weeks investors will get a peak at first quarter earnings. While earnings are expected to be good, growth will likely be in the mid to high single digit range. That would snap a record streak of double-digit earnings growth every quarter for more than three years. The earnings slowdown should cause investors to favor the larger companies in the S&P 500 and Dow Jones Industrial Average, which have lagged over the past several years. Michael Metz of Oppenheimer recently stated that he believes that investors have “excessively optimistic expectations for economic and profit gains” but does see opportunities in certain investment themes. Metz also points out that the opportunities lie in the “relatively inexpensive and well situated large capitalization multi-nationals” and finds the secondary issues to be “richly valued”.

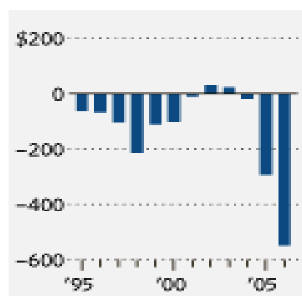
We have felt for some time that as earnings growth slows, leadership will turn to the large capitalization companies. Many of these companies are positioned to benefit from growth outside the United States. Currently, the U. S. is enjoying strong export performance—up over 12% for the last twelve months. This trend is expected to continue and offset the softening in domestic demand. In addition, the larger capitalization indexes are trading at a discount to the small and mid cap indexes.

(trailing 12 mos)	S&P 500	NASDAQ	Russell 2000
P/E Ratio	17.0x	24.4x	38.7x
Yield	1.83%	.50%	1.25%

Source: JP Morgan Asset Management

While earnings could prove to be a disappointment over the next several quarters, it is unlikely that the conditions are present that would lead to a bear market. A weakening economy would likely be cushioned by Federal Reserve rate cuts (see Greenspan/Bernanke Put) and lower bond yields. This would serve as a cushion to the market’s downside. Corporate balance sheets are flush with cash and under-leveraged by traditional standards. This provides opportunities for many to grow earnings per share via buybacks, even as operating earnings may be slowing. Furthermore, managements are aware that if they fail to boost their share prices, they will likely become targets of private equity investors. The private equity boom and the rapid pace of share buybacks is resulting in a shrinking supply of stock—in fact a record $548 billion was taken off

Net Issuance of US Equities
($Billions)



Source: Federal Reserve

the market last year. So the market has the “Bernanke Put” and the “private equity put” working for it over the short to intermediate term. Currently, the S&P 500 is trading at just over fifteen times forward earnings, which amazingly is some thirty percent cheaper than when the bull market kicked off in October 2002.

Summary

The correction in equities may have further to go, but conditions for a bear market do not appear likely at this time. We continue to favor the large caps, where relative valuations are most attractive. Earnings growth is likely to slow but the shrinking supply of equities will serve as a positive backdrop. Recent Fed actions should result in a more normal yield curve over the next several months. We continue to believe the risk/reward favors the short end of the yield curve. Speculation has returned to the markets over the past couple of years reminding us of an old Warren Buffett saying “Be fearful when others are greedy. Be greedy when others are fearful."

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