JAM JOLLEY ASSET MANAGEMENT, LLC

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> *"When the financial history of this decade is written, it will surely speak of the Internet bubble of the late 1990s and the housing bubble of the early 2000s," he went on. "But the U.S. Treasury bond bubble of late 2008 may be regarded as almost equally extraordinary."*
>
> *Warren Buffett—February 28, 2009*

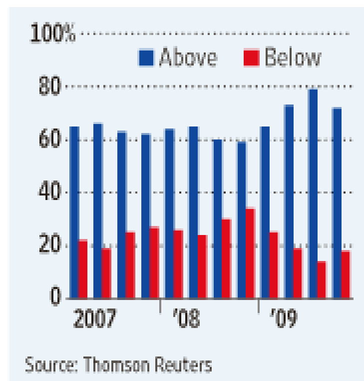
Stocks continued to rally strongly in the first quarter despite a steep February selloff. The rally was driven by higher corporate earnings and the assurance of continued accommodation by the Federal Reserve. The Dow Jones Industrial Average returned 4.82% for the quarter, which was its best first quarter performance since 1999. The S&P 500 index rocketed up by 5.41% during the quarter, but still remains approximately 25% below its all time high reached in October 2007. The best performing stocks have continued to be the most volatile (high beta) and generally lower quality issues. This has been the case since the market bottom in March of 2009. Over the last twelve months, the Russell 2000 has advanced 62.76% while the Dow Jones Industrial Average has returned 46.75%. As can be seen in the chart below, "value" has outperformed "growth" for the past quarter and last twelve months. This in large part has been due to the strong rebound of the financial sector (up over 80% in last 12 months). Recent market data suggest that the stock rally has been fueled by large institutional investors and not individuals. Individual investors have missed much of the equity rally according to various measures of money flows into and out of mutual funds. TrimTabs Investment Research recently reported that investors have pulled $8.7 billion from U.S. equity mutual funds in the past 12 months. In the same period, they moved $13.8 billion into bond funds.

Index	1st Quarter 2010	Trailing 12 months
DJIA	4.82%	46.75%
S&P 500	5.41%	49.78%
S&P Mid Cap	9.09%	64.07%
Russell 1000/Growth	4.64%	49.75%
Russell 1000/Value	6.78%	53.56%
Russell 2000	8.85%	62.76%
NASDAQ Comp.	5.68%	56.87%

Corporate Earnings/Valuations

Earnings for the quarter just ended should prove to be robust. S&P 500 companies are expected to report year over year earnings growth of approximately 37%, well above the historical average of 7% to 8%. Analysts expect revenue growth of around 10% for the quarter. This would be the second straight quarterly gain after four straight quarterly revenue declines. While we are optimistic about earnings, we would remind investors that the revenue and earnings will be compared with the recessionary period when the economy was near its bottom a year ago. As the chart below shows, 72% of companies beat fourth quarter earnings estimates. While we would expect similar trends in the first quarter, is it possible that the equity markets have already priced this into the market? After all, stocks as measured by the S&P 500 have rallied by almost 11% since their February 8th low.

Percentage of S&P 500 companies that beat and missed earnings estimates

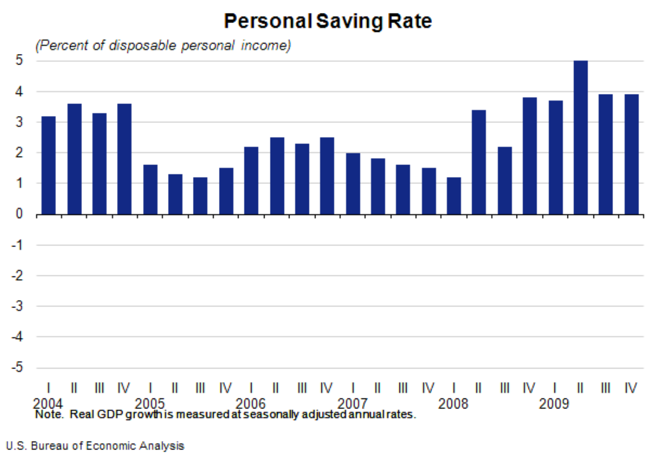


Equity valuations appear reasonable at approximately fifteen times 2010 estimates. Despite the strengthening economy, the Federal Reserve recently promised to keep interest rates near "zero" for an "extended period". The "extended period" has been linked with a time period of six-months, however, recently the Fed made it clear that monetary policy will be "contingent on the evolution of the economy rather than the passage of any fixed amount of calendar time". Market participants seem to have concluded that the rapidly improving economy, coupled with interest rates near "zero", the stock market may be the "only game in town"—at least for the time being.

While analysts and strategists are busy trying to decide whether this will be a V-shaped recovery or W-shaped recovery, the National Bureau of Economic Research (NBER) has not yet officially declared the end of the recession. It is quite interesting that the "bear market" was in full force before the NBER declared we were in recession. Now the "bull market" is thirteen months old and the NBER has yet to declare the recession to be officially over. In any event, (with payrolls increasing by 162,000 last month), the recession is clearly over (likely over in the summer of 2009) and the economist at the NBER will likely concur in short order. It's a good thing we don't utilize the NBER as a "timing tool"!

Consumer—Spending or Saving?

In our "*Investment Outlook—Winter 2009*" (fifteen months ago), we discussed the "paradox of thrift" and the potential impact that it would possibly have on consumption and the overall economy. The "paradox of thrift" essentially argues that if everyone saves, then there is a decrease in consumption which leads to a fall in aggregate demand which leads to a fall in economic growth. A year ago, the personal savings rate rose after more than a thirty year decline (1975-2008). PIMCO's Richard Clarida stated last fall that the U. S. savings rate may exceed 8% in 2010, which would dampen consumer spending. This doesn't appear to be the case as the Personal Savings Rate declined to 3.1% in February, the lowest this metric has been in over a year. It appears that despite the multitude of headwinds facing consumers, they are going to the mall. March retail sales increased 9.1% over last year, the biggest monthly gain since it began keeping records in 2000.



David Rosenberg, Chief Economist at Gluskin Sheff recently put the retail number in perspective. In a recent report Rosenberg stated, "Here we have the greatest stimulus experience in seven decades and retail sales are still down 5% from the pre-recession peak and on a per-capita basis are down 8%". According to Rosenberg, sales are lower than they were in January 2006, even though the population has risen 4.3% over this time period.

A recent study by the Employee Benefit Research Institute (EBRI) found that a majority of Americans (54%) have less than $25,000 in total savings and investments (not including their primary residence) and 27% have less than $1,000. Jack VanDerhei, the research director at EBRI stated that too many Americans would rather engage in fantasy—"I can live off Social Security or I'll just work a little longer" than face the facts and make some tough choices about saving and spending. According to Beth McHugh of Fidelity Investments, "most Americans need to be saving within the healthy range of 6% to 10% of their salary". Ironically, Americans are acting a little like Congress—spend money you don't have and worry about the future later.

Federal Reserve/Fixed Income

Federal Reserve Chairman Ben Bernanke appears to have made all the right moves in rescuing the U. S. economy. In fact, Ben Bernanke has achieved "rock star" status, much like Alan Greenspan did before him (we know how that turned out). Thus far, Bernanke's easy money policy has created growth in the real economy which will provide the earnings needed to keep stock prices rallying. There is widespread belief among economists that the economy is on the verge of providing much needed job growth. The improving domestic economy has allowed the Federal Reserve to slowly remove the quantitative easing measures it put into place during the financial crisis. The big question is when will the Fed raise rates from its current 0% to 0.25% target range? The economy seems to have progressed to a point where emergency rates are no longer necessary and some sort of normalization of rates would be more appropriate. It is likely, that at least initially, the stock market will take the view that somewhat higher rates are a by-product of an improving economic backdrop.

A less accommodative Federal Reserve will create challenges for the bond market. Bill Gross, manager of the world's biggest bond fund at PIMCO recently stated, "Bonds have seen their best days…real interest rates are moving higher, that's the main bear element in the bond market". Gross expects the yields on two-year treasury notes to rise from 1.08% to 1.25%-1.50% over the next year as the economy strengthens and the Federal Reserve begins to raise interest rates. Then there is the simple question of supply and demand. The massive government deficits will need to be financed by the U. S government issuing record amounts of debt. According to Bloomberg News, the treasury has issued $2.59 trillion in debt since 2009. This massive supply of government debt has made investors reassess the risk associated with treasury securities. Recently, two-year notes sold by Berkshire Hathaway in February yielded 3.5 basis points less than treasury bonds of similar maturities. As you know, treasury bonds which are backed by the full faith and credit of the government typically yield less than corporate debt. Is the market saying that it's safer to lend to Warren Buffet than Barack Obama? Debt issued by Procter & Gamble, Johnson & Johnson and Lowe's also traded at lower yields than treasuries (of similar maturities) in recent weeks. Does this imply that the U. S. will eventually lose its AAA credit rating? Moody's predicts the U. S. will spend more on debt service as a percentage of revenue this year than any top rated country except the U. K. Bond manager PIMCO announced in December of 2009 that they would be offering stock funds for the first time. Looks like PIMCO is certainly putting their money where their mouth is.

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