JOLLEY ASSET MANAGEMENT, LLC

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> *"I want to be clear — While I think we can make a meaningful and significant contribution to reducing this problem, we can't solve it. We don't have tools that are strong enough to solve the unemployment problem."*
>
> *Dr. Ben Bernanke (9/11/12)*
> *Federal Reserve Chairman*

Investors are skeptical, the economy is decelerating and earnings growth is slowing. Despite the negative backdrop, stocks climbed the proverbial "wall of worry" and staged a strong quarter as global monetary easing trumped slowing growth. The old adage, "don't fight the Fed", has proven once again to be good advice for investors. The large cap S&P 500 index led the way in the quarter returning 6.35%. Large capitalization stocks have out-performed their small cap counterparts for the bulk of the year with the S&P 500 up 16.44% year-to-date versus a 14.23% return for the Russell 2000 Index (small cap). This is even more evident when one compares the "Nifty 50" (top 50 names in S&P 500 by market cap) with the "Not-So-Nifty" (bottom 450 names in the S&P 500 by market cap). According to Bank of America/Merrill Lynch, the "Nifty 50" returned 17.0% year-to-date, while the "Not-So-Nifty 450" returned 12.06%. Furthermore, the S&P 500 index (market cap weighted) index has returned 16.44% year-to-date compared with the S&P Equal Weight Index of 14.11%. Thus far in 2012, U. S. equities have been a leader among asset classes. The S&P return of 16.44% has outperformed treasury bonds (+4.4%), investment grade bonds (+9.0%), global equities ex. U. S. (+9.1%) and emerging markets (+11.4%).

Index	3rd Quarter 2012	YTD 9 mos.
DJIA	5.05%	12.23%
S&P 500	6.35%	16.44%
S&P Mid Cap	5.44%	13.77%
Russell 1000/Growth	6.11%	16.80%
Russell 1000/Value	6.51%	15.75%
Russell 2000	5.25%	14.23%
NASDAQ Comp.	6.17%	19.62%

Fed Targeting Equity Prices

In 1977, Congress amended The Federal Reserve Act, stating the monetary policy objectives of the Federal Reserve as: "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates." During Alan Greenspan's time as the Federal Reserve Chairman, investors widely felt that the Fed would reduce interest rates to help prevent market declines. This was referred to as the "Greenspan put". The more clandestine Greenpsan Fed never explicitly acknowledged the existence of the "put", as manipulating asset prices was clearly not part of the dual mandate. Stephen Wood of Russell Investments recently stated that the "Bernanke put" is more clearly communicated. Bernanke in a recent speech said that higher stock and home prices would provide further impetus to spending by businesses and households. Essentially, the Bernanke Fed has concluded that driving asset prices higher is one of the only tools left in the Fed toolbox. After all, the Fed cannot cut rates below zero. Peter Hooper, Chief Economist at Deutsche Bank recently stated:

> *"It's pretty clear that the stock market is the most important transmission mechanism of monetary policy right now. That is where you are getting most of the action in terms of lift to the economy. It's the stock market that's going to be carrying the load."*

Economists estimate that gains in stock and real estate could boost economic growth by 0.5% over the next two years and add as much as 500,000 jobs. Bernanke recently stated at Jackson Hole, "It is probably not a coincidence that the sustained recovery in U. S. equity prices began in March 2009, shortly after the Federal Open Market Committee's decision to greatly expand security purchases." Simon Potter, director of economic research at the New York Fed, recently stated that, "We show that since 1994, more than 80 percent of the equity premium on U.S. stocks has been earned over the twenty-four hours preceding scheduled Federal Open Market Committee (FOMC) announcements (which occur only eight times a year) — a phenomenon we call the pre-FOMC announcement drift." Clearly, the Fed has been driving the markets for quite a while now.

The Fed is essentially placing its hopes on stimulating the economy through the wealth effect. Investors clearly have hopes pinned on QE3, but will it work again? According to David Rosenberg of Gluskin-Sheff, "While there is a wealth effect on spending, the correlation going back to 1952 is only 57%." The problem, notes Rosenberg, is that the correlation between spending and after tax personal income is approximately 75%, and disposable personal income declined by .3% in August, its worst month of the year. In addition, Rosenberg believes the savings rate at 3.7% is too low to kick off a spending surge. The current savings rate of 3.7% is below where it was when QE1 (6%) was implemented and when QE2 (5%) was implemented. Ironically, thirteen trading days after QE3 was announced, the stock market is actually lower. The market was up an average of 4% after QE1, QE2, Operation Twist and LTRO. The bottom line is that there is still only so much that we and the Fed itself know about "quantitative easing" and how this will all play out. As James Grant of *Grant's Interest Rate Observer* recently stated, "the Fed is learning by doing" and follows up by clarifying that this is an experiment, "and we are lab rats in the financial markets".

Fiscal Cliff

If Congress doesn't act by Jan. 1, up to $600 billion of expiring tax cuts, new taxes and automatic spending cuts are set to take effect at the beginning of 2013. If the cuts and tax increases all hit at once, it is estimated the impact could be as much as 4-5% of GDP. Obviously, if Congress fails to act the economy would be expected to slow significantly and there would likely be major consequences for the financial markets. A new Tax Policy Center report has estimated that taxes would go up for 2013 by an average of almost $3,500 per household if the U. S. goes off the fiscal cliff and all expiring tax breaks actually expire at year end. Middle class households with income of $40,000 to $64,000 would see taxes rise by approximately $2,000. Households in the top 1% of wage earners with income over $500,000 would see an average tax increase of approximately $120,000. Congress is expected to extend some or all of the breaks; however, there is no agreement. Fidelity Investments recently concluded that there were four possible scenarios that could unfold with regards to the fiscal cliff:

- Punt. A likely scenario is that Congress and the President punt the issue into next year. If this occurs, the tax cuts will not expire and spending cuts would be delayed until the new Congress convenes in 2013.

- Modest Compromise. This would require Congress and the White House to reach compromises on some tax and spending provisions, with the election impacting what those compromises may be.

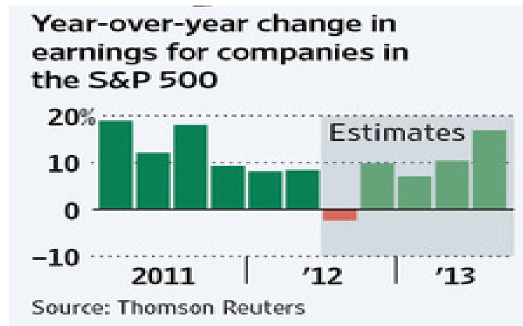
- Over the Cliff. An unlikely scenario according to Fidelity that Congress and the White House are unable to agree on how to delay any of the increased taxes and spending cuts. The economy would then go "over the cliff".

- Grand Bargain. Another unlikely scenario according to Fidelity where Congress and the White House reach a deal addressing taxes, spending and fiscal issues for the medium to long term.

In addition to the fiscal cliff, the U. S. will again approach the debt ceiling early in 2013. It is likely that both issues will be intertwined in any negotiations between Congress and the White House.

Earnings and Dividends

S&P 500 earnings are expected to decline by approximately 3% for the third quarter. If this decline occurs, it will mark the first decline in eleven quarters. Interestingly, analysts believe earnings will bounce back strongly in the fourth quarter and show growth of approximately 8%. Easy comparisons are part of the reason for the projected rebound, but there is also the expectation that the relatively soft economic conditions of the last few quarters are temporary and that normal growth resumes in the fourth quarter.



Consensus estimates for the S&P 500 are around $102, which would imply a price/earnings ratio of approximately 14 times earnings. Consensus forecasts for 2013 are for the S&P 500 to earn approximately $110. It is our opinion that earnings are likely to fall short of estimates in 2013, however, we believe the market has already discounted the likelihood of flattish earnings. Liquidity driven rallies like we are currently in will eventually require some evidence that the easier monetary backdrop is having a positive impact on the economy and profits. Without a clear upturn in growth, the liquidity driven rally will become increasingly suspect.

Dividends remain a bright spot for equity investors. Howard Silverblatt of Standard & Poor's projects a double-digit increase for dividends in the fourth quarter of 2012 and a potential double-digit gain for 2013. Silverblatt points out that the dividend payout ratio (S&P 500) is approximately 34% versus a historical average of around 52%. The average dividend yield for the S&P 500 (ex. non payers) is currently 2.7%, which compares favorably with yields available in bonds, certificates of deposit and money market funds.

Summary

In the coming quarter, investors will be stressing over such issues as the fiscal cliff, debt ceiling, and the elections. Earnings are likely to show their first decline in eleven quarters. Despite this uncertainty, the markets are currently at five year highs. The market's resilience highlights the short-term power of central bank liquidity, especially when coordinated globally. In addition, the zero interest rate policy from the Fed is providing support for equities as investors are scrambling to reposition portfolios into riskier assets in a search for yield. High quality, large capitalization companies currently trade at reasonable valuations and we believe remain the most attractive sector of the market. Corporate America has done a tremendous job navigating through a treacherous economy over the past decade. While we would expect to see market volatility over the coming months, we remain cautiously optimistic.

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