JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 64• Summer 2014**

> *"When will these guys ever learn that maybe, just maybe, these Fed policies aimed at targeting asset prices at levels above their intrinsic value is probably not in the best interests of the nation.*
> *David Rosenberg/Gluskin, Sheff*

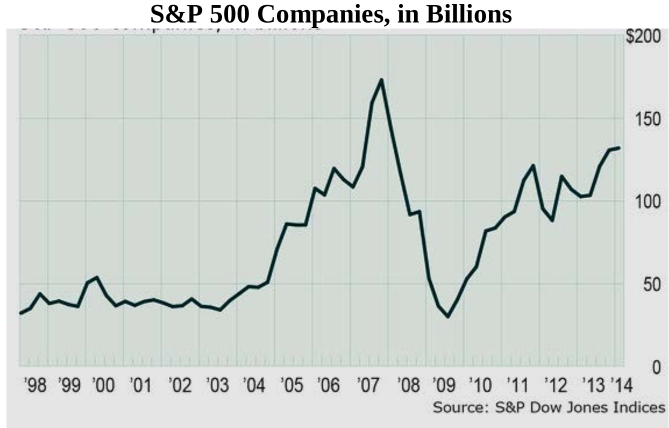
The stock market posted solid second quarter gains despite a sluggish economy and a surprising 2.9% decline in first quarter GDP. Much of the decline in GDP was blamed on bad weather and most economists are predicting a modest expansion in the second quarter. Stocks have moved higher on a bet that corporate earnings will strengthen coupled with a tailwind from global central bankers who are assuring investors that they will remain accommodative for the immediate future. Jason Pride of Glenmede Trust recently commented, "People are recognizing that the feared monetary tightening cycle that they thought was on its way is going to be a heck of a lot more muted". For the quarter, the markets were led by the energy sector which rose by 11.45%. The utility and information technology sectors were also strong, rising by 6.79% and 6.05%, respectively. The Dow Jones Industrial Average lagged the S&P 500 index by a wide margin for the quarter and the first six months of 2014. Small capitalization stocks (Russell 2000) underperformed the larger cap names for the quarter and the first half of the year, despite a strong bounce off the mid-May lows. The Russell 1000 Value and Russell 1000 Growth indexes finished the quarter in a dead heat, but value has been the clear winner for the first half of 2014.

Index	2nd Quarter 2014	YTD 2014
DJIA	**2.83%**	**2.65%**
S&P 500	**5.23%**	**7.14%**
S&P Mid Cap	**4.33%**	**7.50%**
Russell 1000/Growth	**5.13%**	**6.31%**
Russell 1000/Value	**5.10%**	**8.28%**
Russell 2000	**2.05%**	**3.19%**
NASDAQ Comp.	**4.98%**	**5.54%**

Fed Policies and Risk Taking

Recently, Fed officials have started to become wary of market complacency. Market participants and corporations have both become more willing to take on more risk. Corporations are selling debt to finance share repurchases, essentially at all-time highs. Stock buybacks and dividends exceeded $241 billion during the first quarter of 2014, exceeding the previous record of $233 billion set in the fourth quarter of 2007. Ironically, when stocks were cheap in the second quarter of 2009, buybacks and dividends totaled only $71.8 billion. What happened to the old buy low, sell high approach? As we have discussed before, buybacks increase a company's earnings on a per share basis, which has become increasingly important in this period of relatively lackluster revenue growth. Many corporate executives benefit from such transactions as a large part of their compensation comes from stock grants and options, many times tied to the company hitting earnings per share targets. Many companies have been financing these share repurchases with debt financing. Due to the "zero interest rate policy" of the Fed, borrowing costs are extremely low, resulting in a transaction which is accretive to earnings per share. While cash on corporate balance sheets remains at high levels, total corporate debt is now approximately 35% higher than the 2008/2009 peak levels.

Buybacks on the Rise
S&P 500 Companies, in Billions



The zero interest rate policy (ZIRP) has also resulted in an insatiable demand for equities by both individual and institutional investors. Some on Wall Street are referring to this as *T. I. N. A.*, or "*There Is No Alternative*". Yields are non-existent in the fixed income markets, essentially forcing yield starved investors into stocks. Many blue chip stocks currently have yields which exceed those available on fixed income instruments. As we approach year six of ZIRP, and the promises by Fed officials that rates will remain low for the foreseeable future, investors have shown little resistance to increasing exposure to equities despite rising prices. In addition, the investing public has come to believe that the Fed will continue to have an implied "put" below the market in times of market turmoil. Why not, Greenspan, Bernanke and now Yellen have all assured investors that they will be there if needed. The "put" which was put into place by Greenspan, did not go away with the Bernanke Fed and seems likely to remain with the Yellen Fed as well. In response to these Fed policies, the upward march in the market has continued, without as much as a 10% pullback in the last thirty-three months. Historically, markets experience a 10% pullback or correction every eleven or twelve months. This is the longest market run without a market correction since the period from July 1984 to August

1987. While the Fed seems concerned enough to "jawbone" about complacency and increased market risks, they seem unwilling to cut off the easy money due to fears of cutting off the fragile recovery. The dangerous side-effects created by six years of zero interest rates are real, but it is a problem of the Fed's making. As Martin Barnes of BCA Research stated, "They can't have it both ways. If they want to sustain zero interest rates and push up asset prices, how can they not expect to have that with no excesses and no risk taking?"

Wealth Effect

The dual mandate of the Federal Reserve is for price stability and full employment. While it was widely believed that in the past the Fed secretly targeted and attempted to move equity prices, it was typically thought to be outside of the Fed's role. In November 2010, Bernanke admitted that one of the goals of the bond-buying program was to boost stock prices. Bernanke believed that rising asset prices leads to higher consumer sentiment, retail spending, capital expenditures and ultimately hiring. Essentially, it makes the assumption that it all starts with the stock market. In essence, the "wealth effect" believes that the stock market actually drives the economy. I always was of the mind that higher stock prices were a byproduct of a healthy economy. As Barry Ritholtz recently stated, "The Fed, though, seems to think that the stock market is the tail wagging the fundamental economic dog." Obviously, higher stock prices do result in increased spending by those individuals and/or businesses who have benefited from the dramatic move in equity prices. However, it should be pointed out that the "wealth effect" doesn't help everyone equitably. It is estimated that the top twenty percent of Americans own 90% of stocks (by total $ value) in the United States. This would imply that the bottom eighty percent of Americans hold less than ten percent of the stock market (by total $ value). The net result is eighty percent of the American people are essentially not impacted dramatically by the improved markets. Kevin Warsh, a former Fed Governor, went so far as to say that The Federal Reserve's easy-money policies are benefiting the rich at the expense of the poor in a "reverse Robin Hood" scenario. Perhaps the Fed might make the case that the lower income Americans will benefit from the "trickle-down" effect, but thus far that doesn't seem to be the case.

Valuations

The equity markets have essentially traded to new highs on the back of share repurchases. Investors now need some assurance that revenue and profit growth will accelerate to keep stock prices moving higher. After a weak first quarter (harsh weather) where the GDP declined by 2.9%, economists believe the economy advanced by approximately 3% in the quarter just ended. According to FactSet Research, S&P 500 profits are expected to rise by just under 5% for the second quarter. This would be well above the 2.1% earnings gains from the first quarter which was hampered by the harsh snowstorms in the first quarter. For the third and fourth quarters of 2014, analysts are projecting earnings growth of 9% and 10%, respectively. This would result in earnings growth for the full year 2014 of approximately 7.5%. Currently, the S&P 500 is trading for approximately 16 times earnings estimates, above the ten year average price/earnings multiple of just under 14 times. We continue to favor the large capitalization stocks over the mid (S&P Mid-Cap 400) and small cap (S&P Small-Cap 600) issues which trade at 19 times earnings and 20 times earnings, respectively.

Fixed Income

In the first half of 2014, the yield on the ten-year treasury bond declined from 3.0% to 2.5%. Ironically, at the beginning of 2014 most bond investors expected bond yields to rise rather than decline. However, as central bankers around the globe moved towards easier monetary policy, bonds rallied, pushing yields lower. For the first half of the year, the thirty-year treasury bond was the best performing asset class, up a whopping 12.6%. We continue to be focused on the short dated maturities (investment grade) and adjustable rate preferred issues. We believe that the odds favor higher rates over the next several years and are simply not willing to risk our clients' principal with rates near record low levels.

Strategy

The Fed's zero interest rate policy has left very few alternatives for investors seeking any yield and/or return. The markets have not experienced a 10% correction in the last thirty-three months. Since the market bottom on March 6, 2009, the S&P 500 index, the S&P Mid-Cap index and the Russell 2000 index have produced cumulative returns of 221.2%, 280% and 265.5%, respectively. While valuations are reasonable, given the current level of interest rates, we are not naïve enough to believe that zero rates will last forever or that we will never experience another economic recession. Clearly, market risks are rising and we believe our focus on high quality, large capitalization issues is appropriate from a risk versus reward perspective. A "bear market" is unlikely given current levels of interest rates, but we think a "correction" is way over-due. We actually think a "correction" would be healthy for the markets, as we could cleanse some of the excesses and speculative market activity. We believe our conservative value focus, where we focus on risk versus reward, will serve our clients well in the quarters to come. Now is an excellent time for investors to reassess their investment objectives and make sure that their asset allocation is in line with those objectives. Rebalancing portfolios should always be a proactive rather than reactive process. Please feel free to call if you would like to review your current asset allocation and/or discuss the markets. Thanks again for the confidence you have placed in Jolley Asset Management, LLC.

Frank G. Jolley, CFA

JAM JOLLEY ASSET MANAGEMENT, LLC

210 Bryant Street, Suite A
P.O. Box 7967
Rocky Mount, NC 27804
(252) 451-1450 Toll Free (877) 4-JOLLEY
Web Site: www.jolleyasset.com
E-Mail: fjolley@jolleyasset.com

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