JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 62• Winter 2014**

> *"Several (Fed Officials) commented on the rise in forward price-to-earnings ratios for some small-cap stocks, the increased level of equity repurchases, or the rise in margin credit."*
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> *Minutes from Federal Open Market Committee (From meeting held December 17-18, 2013)*

The stock market was virtually unstoppable in 2013. Instead of worrying about lackluster economic growth, investors focused on the Federal Reserve and Ben Bernanke's next move. The S&P 500 Index advanced by 29.6%, its best year since 1997, while the Dow Jones Industrial Average increased by 26.5%, its best showing since 1995. Including dividends, the S&P 500 and the Dow Jones Industrial Average returned 32.4% and 29.6%, respectively. U. S. equities outperformed all other major asset classes, handily surpassing a 20.6% rise for the MSCI World Index (ex US), a decline of 1.5% for investment grade corporate bonds, a 13.3% decline for long-term treasury bonds and a 27.8% decline for gold. Market leadership continued to come from small capitalization stocks as the Russell 2000 returned 38.8%. The Nasdaq Composite was also an outperformer, up 38.3% in 2013. Market participants embraced risk in 2013 as the "Bernanke Put" seems to have become a permanent fixture. "High-beta" momentum stocks continued strong into year-end as hedge funds and high frequency traders favored price momentum over valuation metrics. Growth strategies trumped value strategies in the past year as evidenced by the 33.5% return for the Russell 1000 Growth Index versus 32.5% for the Russell 1000 Value Index.

Index	4th Quarter 2013	Yr. Ended 12/31/13
DJIA	**10.11%**	**29.57%**
S&P 500	**10.51%**	**32.39%**
S&P Mid Cap	**8.33%**	**33.50%**
Russell 1000/Growth	**10.44%**	**33.48%**
Russell 1000/Value	**10.01%**	**32.53%**
Russell 2000	**8.72%**	**38.82%**
NASDAQ Comp.	**10.74%**	**38.32%**

Bernanke's Fed

Ben Bernanke will step down as Fed Chairman later this month after a tumultuous seven year period. Bernanke was appointed to the Fed Chairman position in 2006 by President George W. Bush. Under his term, Bernanke confronted a housing bust, mortgage industry collapse, and global financial crisis. He made bold, unprecedented moves that pushed the central bank to the limits of its authority. But he, like many economists, lawmakers, and policy makers, failed to foresee the crisis in the first place, allowing bubbles in the economy to expand to their breaking point. In 2008, the Bernanke Fed helped to engineer the bailout of the financial system. While controversial, many believe the bailouts were necessary to prevent a global financial depression. At the heights of the financial crisis (2008), Bernanke embarked on the first "quantitative easing" or bond-buying program in an attempt to lower mortgage rates and stimulate the economy. The Federal Reserve was essentially "boxed in" at that point, as rates had already been cut close to zero. Essentially, "quantitative easing" was one of the few tools left in the Fed's toolbox.

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 the economy would be boosted by the "wealth effect", which would stimulate consumer spending and reduce unemployment. Since 2008, the Federal Reserve balance sheet has expanded to close to $4 trillion dollars, boosting equity prices dramatically. The chart below shows a very high correlation between stock prices and the Fed balance sheet.

Source: LPL Financial, Federal Reserve, Bloomberg data 06/17/13

In our last "*Investment Outlook—Fall 2013*", we focused on the fact that the markets were being driven by multiple expansion rather than earnings growth. In 2013, S&P 500 earnings are estimated to grow by approximately 4%, while equity prices rose by over 32%. The markets have now gone twenty-seven months without a ten percent correction. The markets typically correct ten percent every eleven months. This bull market is the fourth strongest in history up over 173%, cumulatively. In terms of time, the current bull run ranks as the sixth (out of twenty-six) longest in S&P 500 history. The Bernanke Fed has even convinced the most bearish prognosticators to throw in the towel and adopt a bullish stance. In recent months, we have witnessed the return of a speculative investment climate that has not been seen since 1999. Bernanke wanted the "animal spirits" back and it appears he got just that. Margin debt rose for the sixth straight month in November and stood at a record $412.4 billion on November 30, 2013 according to the NYSE. The Renaissance

IPO (initial public offering) index was up 54.3% in 2013 and the Goldman Sachs Most Short Rolling Index (index comprised of most heavily shorted names) returned 48.1%. Fifty years ago, the average stock was held for more than eight years. By 2010, the average stock was held for five days. Today, it is estimated that half of all stock trades are made by automated "high-frequency" traders. Like 1999, valuations once again don't seem to matter. Amazon.com, Facebook and Netflix trade at price/earnings multiples of 1405, 136 and 302, respectively. Investors have gained confidence in the Fed's ability to utilize monetary policy to keep the economy afloat and keep a floor under asset prices, through any economic environment. Even our lawmakers have watched the Fed manage the economy and markets, enabling further Congressional dysfunction. As long as the markets are heading higher, our lawmakers have little urgency to address the economic problems facing our country. On January 8th, 2014, the minutes from the Federal Open Market Committee meeting held December 17th-18th meeting were released. The following excerpt is very telling, "Several (Fed Officials) commented on the rise in forward price-to-earnings ratios for some small-cap stocks, the increased level of equity repurchases, or the rise in margin credit." While the comments will likely be seen as "jawboning" by the Fed, it appears that the FOMC clearly sees the problems that "quantitative easing" and the "zero interest rate policy" has created in the equity markets.

Market Outlook

Two years ago at the end of 2011, the forward price/earnings ratio for the S&P 500 stood at 12.9 times. It has expanded to 15.7% at the end of 2013. Essentially, the market rose by approximately 50% over the two year period, while earnings growth approximated 12% (same time period). Despite the multiple expansion, the current price/earnings ratio stands essentially in line with the long-term historical average. If we assume that interest rates have bottomed, we believe it would be unlikely to see further price/earnings multiple expansion going forward. This would imply that any further upward move in the market would depend upon earnings growth. The consensus earnings estimate for the S&P 500 for 2014 is $122. Assuming we hit the consensus estimates and trade at 16x earnings, we could see the S&P 500 trade up approximately 6% over the next year. We believe the case for the small and mid-cap stocks is less compelling. The trailing price/earnings multiples for the S&P Mid Cap 400 and S&P Small Cap 600 were 20.4 and 21.4 times, respectively.

By some measures, the current stock market is more expensive than the casual observer would think. The cyclically adjusted price-earnings ratio (Shiller P/E) is currently closer to 25 times earnings, approximately 50% above its historical average. Warren Buffett's favorite market indicator looks at the value of all publicly traded securities as a percentage of GDP. Buffett said "If the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you. If the ratio approaches 200% as it did in 1999 and part of 2000—you are playing with fire." Today, that number is approximately 134%, well above the sixty-year average of 78%.

The "presidential stock market cycle" says that stocks perform better or worse, depending on the year of a president's term. This is the second year of the four-year cycle which typically is the worst of the four years. In the second year of the cycle, elected officials tend to focus on things other than "pumping up the economy". Also worth noting is that the second-year sub-par performance is actually even worse for the first nine months of the year; where the market actually loses 0.5% on average.

Summary

In the last two years, we have seen stock price gains outpace economic growth by a wide margin. This phenomenon has made it more difficult to find stocks that meet our investment criteria. We believe that a "market correction" is inevitable but doubt a "bear market" is likely as returns on cash remain at essentially zero. Bonds have likely entered a secular bear market that could last twenty years or more. The Bernanke Fed has essentially made stocks the only game in town. While we are not bearish on high quality, blue-chip stocks, we do believe we may enter a period of below average returns. We would continue to caution against chasing the small and mid-cap names and indexes, as the recent run-up in those areas has resulted in stretched valuations. We would likely become more aggressive buyers in the event of a meaningful pullback. While not market timers, we cannot rule out the possibility of reducing equity exposure somewhat if stock price gains continue to far outpace earnings growth. We will continue to focus on investing with a "margin of safety" and attempt to sidestep the areas of the markets that we consider ripe with speculation. Our "value investing" strategy has served us well through other difficult periods before, including the closet-indexing craze, the "internet bubble" and the "financial crisis".

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