JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 67• Spring 2015**

On Fed tightening:
"If financial conditions tighten a lot, then presumably we're going to slow down or we're going to pause for a while," he said. "Conversely, if the market doesn't react at all—stock market goes up, bond market doesn't move—presumably we're going to want to do more (tightening)." *William Dudley*
President, NY Federal Reserve

Most major market indexes advanced again in the first quarter ended March 31, 2015. Small and mid-cap indexes led the way as investors tried to side-step the impact of a strong dollar which has reduced profitability of many multi-national companies. For the quarter just ended, the S&P 500 Index returned .95% while the Dow Jones Industrial Average returned .36%. The S&P 500 index has now generated positive total returns for the last nine quarters. Zero interest rate policies (ZIRP) around the globe have forced many investors into riskier, but potentially higher-returning investment vehicles such as stocks. As we have discussed in previous letters, the markets are essentially being driven by T.I.N.A (there is no alternative).

Index	1st Quarter 2015
DJIA	**.36%**
S&P 500	**.95%**
S&P Mid Cap	**5.31%**
Russell 1000/Growth	**3.84%**
Russell 1000/Value	**-.72%**
Russell 2000	**4.32%**
NASDAQ Comp.	**3.48%**

There was narrow leadership in the quarter, as only health care (+6.1%) and consumer discretionary (+4.4%) actually out-performed the benchmark S&P 500. Utilities (-6.0%), energy (-3.5%) and financials (-2.5%) were the biggest drags on the index during the first quarter. Of the ten S&P sectors, six were up and four were negative for the quarter. One of the positive sectors was information technology, which squeaked out a .17% gain for the quarter. However, without Apple, that sector would have actually declined by 2.59%. The S&P Mid-Cap Index and Russell 2000 Index were the standout index performers during the first quarter, with returns of 5.31% and 4.32%, respectively. According to Bank of America / Merrill Lynch, the top 50 (nifty-fifty) names in the S&P 500 index lagged the market and actually were down for the quarter (-.37%) while the bottom 450 names in the index generated a positive return of 1.15%. This can largely be attributed to the rotation into domestically oriented areas of the market. The Russell 1000 Growth Index returned 3.84% for the quarter, far outpacing the Russell 1000 Value Index, which was down .72% for the quarter.

Obsession with the Federal Reserve

In our recent investment letters, there has been much commentary about the role of the Federal Reserve. The central bank has become the primary focus of investors in recent years. This is largely a result of twenty-eight years of Fed policies, where the Fed has essentially provided a "put" beneath the markets. In essence, whenever there was financial difficulty in the markets, the Fed added monetary liquidity and encouraged risk taking in the financial markets to avert further deterioration. This phenomenon began with the Greenspan Fed (1987-2006) and has continued with the Bernanke Fed (2006-2014) and now the Yellen Fed (2014-current). It seems as though the Fed's mandate, which is to promote maximum employment and stable prices, has taken a back seat to running the country's stock and bond markets. Former Fed Governor Kevin Warsh, recently stated, "The markets think they have Yellen's number, that she will never allow markets to go down, that is a very dangerous development." Stock prices and market valuations have gone from being a reflection of underlying economic trends to being a function of Federal Reserve policies. Interest rates have not been raised since 2006 and have hovered at zero since 2008. Let's also not forget "quantitative easing" that the Fed implemented in an attempt to jump start the economy.

Today, investors hang on every word from the Fed, as the economy seems to have improved enough for the Fed to begin to "normalize" interest rates. Removing the word "patient" (with regards to raising rates) from the Federal Reserve statement on March 18th was recently interpreted as meaning that the Fed might finally proceed with its initial rate increase. However, Yellen managed to hedge her statement to appease the markets and convince participants that monetary policy would remain extremely accommodative and data dependent. Is the economy so fragile that after six years of expansion that we must tiptoe about a single word in a Fed statement? Why is the Fed so concerned about language that may result in a correction in the equity markets? The S&P 500 index has now gone forty-two months without a ten percent correction—any time it pulls back, Fed governors are trotted out to "jawbone" the markets back up. Wouldn't it actually be healthy to see a correction? Recent statements from William Dudley, President of the New York Federal Reserve Bank, essentially substantiate the Fed's focus on the stock market. Dudley recently stated, "If financial conditions tighten a lot, then presumably we're going to slow down or we're going to pause for a while," he said. "Conversely, if the market doesn't react at all—stock market goes up, bond market doesn't move—presumably we're going to want to do more (tightening)." Is it any wonder that investors have become obsessed? Ed Yardeni recently commented, "This is not about investing, this is all about the central bankers….

These markets are all rigged, and I don't say that critically, I just say that factually."

Earnings Recession?

For the first time since 2009, S&P 500 revenues and earnings for calendar 2015 are expected to decline. Coming into the year, S&P 500 earnings were projected by analysts to rise by approximately 6% for 2015. The main reasons for the earnings weakness are the 50% drop in crude oil prices and the 20% rally in the U. S. dollar. If we were to exclude these two factors, earnings growth would be close to 10% in 2015. Investors may ignore this "earnings recession" as the oil price decline and dollar strength are largely one-time events that will likely prove to be transient in nature. To clarify, an "economic recession" is defined as two straight quarters of contraction and an "earnings recession" would be characterized as two consecutive quarters of earnings decline. To date, the market has not been punishing companies that have issued negative EPS guidance for the first quarter. This is not unusual according to Dan Suzuki of Bank of America/Merrill Lynch, "markets have historically looked through this impact (stronger dollar), resulting in multiple (price/earnings) expansion. Suzuki expects financials, consumer discretionary, healthcare, industrials, information technology and telecommunications to show earnings gains in 2015 while energy and materials are estimated to show earnings declines. The utility sector is expected to report flat earnings for 2015.

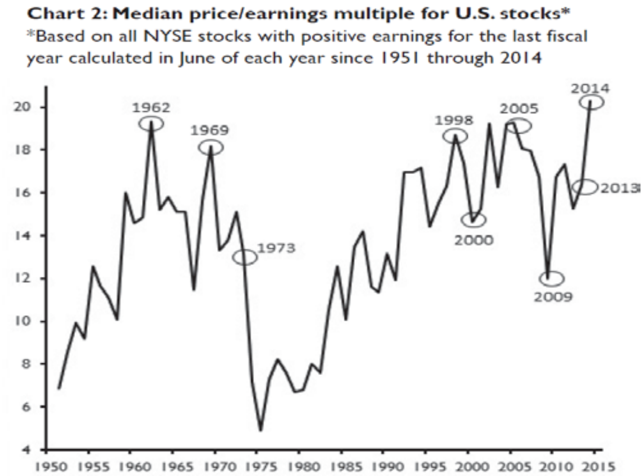
S&P 500 Quarterly EPS Estimates (Chart 1)

Quarter	EPS Growth (estimates)
Q1-2105	**-2.4%**
Q2-2015	**-3.6%**
Q3-2015	**-.01%**
Q4-2015	**1.5%**

Source: Bank of America/Merrill Lynch

Valuations

The S&P 500 index began 2015 trading at approximately eighteen times trailing earnings. This puts the current price/earnings ratio at a level higher than approximately 75% of the time periods since 1945. Most market followers believe the multiple is reasonable given that it is well below the peak of thirty times earnings at the market top in 2000. We must remember that lower interest rates typically mean lower discount rates and higher price earnings ratios. That being said, we should point out that the median stock on the New York Stock Exchange is currently trading at a (post-war) record high price/earnings ratio (see chart 2 below).



So while S&P 500 price/earnings multiples are well below the peak, the median stock in the index is at peak levels. This is the inverse of what happened in the 1999-2000 period. In that period, the S&P 500 index was at a record high, while median stock traded at a reasonable multiple. In our *Investment Outlook—Spring 2000*, we stated, "While the S&P 500 appears relatively expensive on the surface at 24 times forward earnings, the median price/earnings ratio is a more reasonable 13.5 times." As one might expect, in a market where growth is scarce, investors are willing to pay a premium valuation. For example, we discussed earlier that small cap stocks are favored by many due to the fact that they have less exposure to foreign currencies. Currently, the small cap (Russell 2000) is trading at just under twenty-three times earnings (ex-neg earnings). As Warren Buffett stated, "You pay a very high price in the stock market for a cheery consensus." This holds true not only for the small caps, but for any area of the market where investors can find growth. Ironically, as contrarian value managers, we are finding the most compelling long term values in areas of the market that others are avoiding.

Summary

Due to plummeting energy prices and the higher U. S. dollar, it appears that S&P 500 earnings will decline for the first time since 2009. The Federal Reserve has indicated that it might begin to raise rates during 2015. The Fed has stressed that any such move would be "data dependent" and given the current state of the currency markets, we would not be surprised to see the Federal Reserve delay any such rise until 2016. We are concerned that investors have become complacent due to the belief that the Fed has their back. Market valuations are rich, but due to T.I.N.A (there is no alternative), we are not convinced that we are ready to enter into a full blown bear market phase. We do believe, however, that a correction is likely during calendar 2015. After all, we have not experienced a 10% correction in approximately forty-two months. We are finding value in many unloved sectors of the market and believe that, with patience, those values will reward our clients with a reasonable rate of return. 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.

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