JAM JOLLEY ASSET MANAGEMENT, LLC

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> *"The idea of expanding into areas like equities might be a good thing to think about," yet is not "something we need now," Yellen said, noting that (for now) The Fed is more restricted in which assets it can purchase than other central banks. "If we found, I think as other countries did, that they could reach the limits in terms of purchasing safe assets like longer-term government bonds, it could be useful to be able to intervene directly in assets where the prices have a more direct link to spending decisions."*
>
> *Janet Yellen 9/29/16*

Stocks continued their upward march in the third quarter of 2016. Investors quickly dismissed the impact of the Brexit vote early in the quarter and pushed the market to a new high in mid-August. Stocks have now generated positive returns for seven consecutive months. For the quarter the S&P 500 returned 3.85% versus 1.4% for investment grade bonds, gold (+.01%) and long term treasuries (-0.6%). Investors shifted to riskier stocks in the quarter just ended, with the NASDAQ and Russell 2000 Index (small cap) indexes advancing by 9.69% and 9.05%, respectively. For the quarter, technology (up 12.4%) and financials (up 4.0%) were the leaders and ironically the only two sectors to outperform the S&P 500 index. As we warned in our *Investment Outlook—Summer 2016*, slow growth sectors such as consumer staples (-3.3%), utilities (-6.7%) and telecommunications (-6.6%) all lost ground during the quarter. Investors who bought those sectors as bond surrogates are now realizing that chasing yield can be dangerous to your financial health. More cyclical market sectors all posted positive total returns for the quarter while health care managed a slight gain (+0.5%). For the quarter the Russell 1000 Growth Index outperformed the Russell 1000 Value Index by 1.1% however still trails the value index by 4% for the year.

Index	3rd Quarter 2016	2016 YTD 9 Mos.
DJIA	**2.78%**	**7.21%**
S&P 500	**3.85%**	**7.84%**
S&P Mid Cap	**4.14%**	**12.40%**
Russell 1000/Growth	**4.58%**	**6.00%**
Russell 1000/Value	**3.48%**	**10.00%**
Russell 2000	**9.05%**	**11.46%**
NASDAQ Comp.	**9.69%**	**6.08%**

Fed Backlash/Policy Change?

The most recent *Barron's Magazine* had an article entitled, "The Truly Scary Clowns: Central Bankers". Barron's seems to have nailed it this time surmising that "eight years after the global financial crisis, the time may finally be approaching to move away from crisis policies. Those include zero interest rate policies, including some with negative interest rates. Those central bank policies also include massive securities purchases, distorting virtually all asset class prices. British Prime Minister Theresa May obviously understands the side effects of "quantitative easing (QE)" and recently stated, "People with assets have got richer. People without have suffered. People with mortgages have found their debts cheaper. People with savings have found themselves poorer." QE and zero interest rate policies have only created asset price inflation—not the economic benefit promised by the central bankers. Bill Gross of Janus, recently stated, "central banks have managed to increase asset prices without substantially stimulating the economy." Gross also points out that low interest rates make it difficult for the act during another downturn and "keep zombie companies alive." Gross stated, "Capitalism, almost, commonsensically, cannot function well at the zero bound or with a minus sign as a yield."

Banks, insurance companies and pension plans will see major financial problems if the Fed and other central banks continue to operate as they are currently. Ironically, the Fed set out to save the banks with ultra-low interest rates, some eight years ago. Perhaps the Fed and other central bankers finally realize this insanity must stop. Recently the Bank of Japan announced they would begin to target the yield curve and Bloomberg reported that the European Central Bank may ease back on bond purchases. Yellen even floated a trial balloon stating, "The idea of expanding into areas like equities might be a good thing to think about." Perhaps Yellen wants that safeguard to prop up equities in the event the markets weaken as they normalize interest rate policies. Presently, the Fed seems on course to raise its federal-funds rate target in December. According to Bloomberg the futures market puts that probability at 64.3%. While we believe that we have likely seen a generational low in interest rates, we must remember that Yellen is essentially scared of "her own shadow" and may backtrack once again. While the Fed states they are "data dependent", they are essentially "market dependent".

Earnings/Valuations

Despite the massive move in stocks since the March 2009 bottom, equity valuations still appear reasonable, particularly given the current interest rate backdrop. The chart below shows current valuations versus the average for the past twenty-five years. Obviously when using forward price/earnings multiples one must assume that estimates for the coming year are accurate which may or may not prove to be correct. The third quarter of 2016 will likely represent the sixth consecutive quarter of profit declines. Most analysts expect the profit outlook to improve in 2017 and are projecting a 14% rise in S&P 500 earnings. Much of the improvement in earnings is expected to come from easy comparisons for the energy sector and less currency headwinds which should benefit U. S. multinationals. We also should keep in mind that in December it is likely that the Federal Reserve could raise interest rates for only the second time in this economic cycle.

Metric	Latest	25 Yr. Avg.
Forward P/E	16.8x	15.9x
CAPE (Shiller)	26.6x	25.9x
Dividend Yield	2.2%	2.0%
Price/Book	2.6x	2.9x
Price/Cash Flow	11.7x	11.4x

Source: JP Morgan

Aging Bull Market?

The stock market remains near record highs, and bonds are up as well—an unusual combination. Many say this may be the most hated bull market in history. Perhaps this is due to the fact that the economy and corporate profits are lackluster, essentially this bull move has been driven by Federal Reserve policies and their super dovish monetary policy. As we have mentioned on numerous occasions investors have been left with essentially no alternatives—unless they sit in cash and generate negative real returns after taxes and inflation. Recently this bull market which began in early 2009 became the second longest in history (92 months old), trailing only the 1987-2000 bull market (115 months). In terms of returns this bull move has resulted in returns of 220% well below the 417% return from the 1987-2000 bull market.

Assuming the Fed decides to finally begin to normalize rates it would seem logical that the equity markets would become more volatile. Higher rates can probably be tolerated by equity investors if earnings growth accelerates from current levels. Without an acceleration we are likely looking at a correction in the markets. We also must contend with uncertainty associated with the upcoming election. This election in particular seems troublesome as most people that we talk to are voting "against" a particular candidate rather than "for" a candidate. For that reason, the likelihood for a post-election disappointment seems high, no matter who wins. In our opinion, this increases the likelihood of a near term correction in the market.

Investment Strategy

Rather than attempt to time the markets, we believe in adhering to a strict value discipline for the long term. We believe that market timing is a futile exercise, one must get the timing right on both the sell and the buy, which is extremely difficult. Not to mention possible tax consequences for any gains incurred. As our clients know, our focus remains on buying companies at a discount to their estimated intrinsic value—which creates a "margin of safety". Utilizing a value approach and investing at a discount is at its very core attempting to minimize risk. Seth Klarman of Baupost group stated, "There's no such thing as a value company. Price is all that matters. At some price, an asset is a buy, at another it's hold and at another it's a sell." A value investor many times must be a contrarian and step away from the consensus mindset. In 1979 Warren Buffett stated, "The future is never clear; you pay a very high price in the stock market for a cheery consensus." With that contrarian trait etched in my brain, the comment below from Fred Hickey, author of the *High Tech Strategist Newsletter*, stood out in my mind when I read it. On September 27, 2016, Hickey stated that the five highest valued stocks in the market are all technology companies. The five companies were: Apple, Alphabet (formerly Google), Microsoft, Amazon and Facebook. He noted that even in the insane market for technology shares in 2000 only three of the top five companies were technology issues. The total market capitalization of the five companies currently approximates $2.35 trillion dollars and represents just under 12% of the S&P 500. Without a doubt most fund managers own all of these names because they are unwilling to take on the "benchmark risk" of not owning them. Their bosses won't fire them if their portfolios look like the index. While we believe that all five of these are wonderful companies, Apple is the only one of the five where we believe the valuation is currently attractive. We understand that most people are comfortable going with the consensus, but in the long run the crowd is usually wrong.

Summary

Adhering to a value discipline is not always the easiest or the sexiest course of action. In today's environment of media hype and irresponsible financial journalism; discipline is not only difficult, but often made out to be old-fashioned. Buying what is popular has never worked on Wall Street. That is precisely why Jolley Asset Management was formed, to provide a vehicle whereby our focus and discipline could be preserved. We attempt to control risk by asset allocation decisions rather than "timing" the market. Our "value" style and our focus on "downside risk" tends to steer us to depressed sectors of the market, where expectations are low and where much of the bad news may already be priced in. We believe this lowers the risks to portfolios in difficult market periods. Unfortunately no style of portfolio management is able to capture returns in excess of the "risk-free" rate without the potential for short term setbacks and volatility. Thanks again for the confidence you have placed in Jolley Asset Management.

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