JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 78• Winter 2018**

> *"During my 87 years I have witnessed a whole succession of technological revolutions. But none of them has done away with the need for character in the individual or the ability to think."* *Bernard Baruch*

Led by the Dow Jones Industrial Average, the markets continued their strong advance in the fourth quarter. Part of the strength in the fourth quarter could be attributed to the prospects of corporate tax reform. Lower corporate tax rates are expected to boost earnings on the S&P 500 by approximately 6-8%. The 21.8% return for the S&P 500 Index was its best year since 2013. The S&P 500 has now advanced 14 consecutive months (total return), the longest stretch ever (since 1928)! While the mantra "buy the dip" still lives, there were essentially no dips to buy in 2017. The biggest intra-year decline in 2017 was 3%, significantly below the longer-term average of 14.1%. We believe the melt-up (accompanied by no volatility) is largely a by-product of supply and demand. Massive central bank balance sheet expansion, coupled with a shrinking supply of stock has forced equity prices higher. (More on that later.) The markets were led by growth issues in 2017 as evidenced by the Russell 1000 Growth Index outperforming the Russell 1000 Value Index by 16.55%, the widest spread since 2009. Value did end the quarter strong, helped by the expected impacts of tax reform. Small and mid-cap stocks were laggards during 2017 as investors favored large capitalization technology issues with predictable earnings growth.

Index	4th Quarter 2017	2017 12 months
DJIA	10.96%	28.11%
S&P 500	6.64%	21.83%
S&P Mid Cap	6.25%	16.24%
Russell 1000/Growth	7.86%	30.21%
Russell 1000/Value	5.33%	13.66%
Russell 2000	3.34%	14.65%
NASDAQ Comp.	6.27%	28.24%

Supply/Demand Dynamics

As you know, price is essentially a function of supply and demand. A decline in the number of initial public offerings coupled with merger activity has shrunk the number of public companies in the U. S. dramatically. Over the past two decades, the number of publicly listed companies trading on U.S. exchanges has been cut almost in half — from about 7,300 to 3,700. This decline has occurred despite a growing economy and population. Most of the decline happened after the dot-com bubble and bust. In addition, due to the zero interest rate policy of the Federal Reserve, corporate buybacks (financial engineering) have become the norm, further shrinking the supply of stocks. It is estimated that share buybacks and mergers and acquistions have shrunk the stock market by approximately $6 trillion dollars over the past twenty years.

While the supply of shares has been shrinking, the demand for shares has been driven by central bank asset purchases. Michael Hartnett, Chief Investment Strategist at Bank of America/Merrill Lynch, estimated that central banks bought $3.6 trillion in financial assets in 2017. This represents the most central bank buying since the global financial crisis began in 2007. The chart below shows a high correlation between the S&P 500 index and central bank balance sheets. While the Federal Reserve has slowed its purchases, the slack has been more than made up for by the ECB, BOJ and Swiss National Bank. Hartnett believes that increase in central-bank balance sheets has held down bond yields and supported stock prices

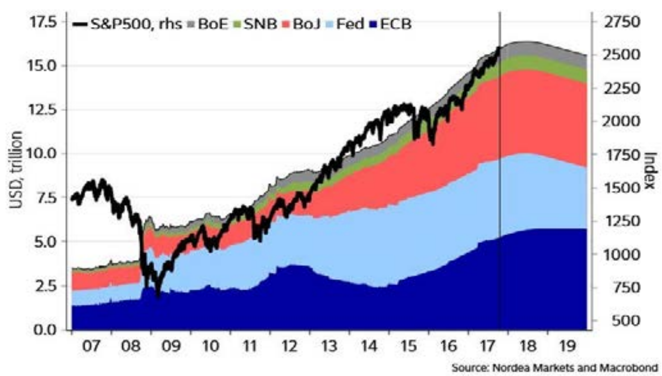

Chart 1: Era of lower yields & higher stocks

Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, Haver

So, there you have it. Central banks have essentially driven up share prices with few setbacks since the financial crisis. The stock market is trading more on supply/demand factors than underlying fundamentals. Asset purchases by central banks coupled with a shrinking supply of shares available (due to share repurchases and mergers and acquisitions—fueled by ultra-low interest rates) has resulted in essentially a melt up in equity prices.

Equity Market Thoughts

The stock market's climb over the last eight years and low volatility (buy the dip/buy every dip) has made investing appear easy for the masses. For the time being (and in hind-sight) it appears that for all practical purposes the central bankers were able to make investing a one-way street. This will not always be the case, trust me on this. At some point fundamental investing will once again take front and center. During these times, we must remind ourselves of Benjamin Graham's quote in the *Intelligent Investor*, "A stock is not just a ticker symbol or an electronic blip; it is an ownership interest in an actual business, with an underlying value that does not depend on its share price." J. P. Morgan estimated recently that passive and quantitative investors now comprise 60% of equity assets versus 30% a decade ago. They also estimate that only 10% of trading volumes originate from fundamental discretionary traders. Passive strategies and "black box" algorithmic investing strategies which are currently dominating the market are currently programmed with a bias to buy and there is no factor in the algorithm for valuation. It makes one wonder if they will all decide it is time to exit at the same time? At that point, fundamental investing, where one focuses on a company's valuation will become prioritized. Owning a basket of today's high flyers will likely be a disaster for investors in the next down cycle. Black box/quantitative investors plan on exiting before that occurs (rules based timing) while passive investors plan to ride with the highflyers (hence the term passive) through thick and thin. We know how that turned out in 2000-2002 when the last "indexing" craze unwound and human emotions resulted in the "passive" strategies being abandoned. In the end, equity investors own a fractional share of a business and the price one pays for that business is probably the most important factor in determining the ultimate return it generates.

Since nobody is focusing on valuations in this market, perhaps taking a look (at valuations) might be a good exercise. While valuation measures never seem to work well as a timing tool, they do help investors as they factor in expectations about future returns. Currently the U. S. stock market trades at 25 times trailing earnings versus a long-term average of approximately 16 times earnings. The forward price/earnings based on 2018 estimates (aided by corporate tax cuts) look more reasonable at approximately 18 times earnings. In lower interest rate environments, price/earnings multiples tend to be higher, making today's multiple, while elevated, somewhat reasonable. Currently, the U. S. stock market is one of the most expensive in the world. The MSCI Euro index trades at 18 times trailing earnings and the MSCI Japan index trades at 15 times.

The metric that Warren Buffett once called his favorite indicator is the total market cap/GDP indicator. This ratio gives a rough measure of whether the market is overvalued or undervalued. At the peak of the tech bubble in 2000 this index was at 145% versus today's level of 139% (see chart below). This measure is flashing caution to investors currently.

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We believe today's relatively high valuations are a function of the supply/demand factors we mentioned earlier. History would suggest that investors should plod carefully going forward with great attention to portfolio holdings and the underlying valuations of those holdings. Indexing or passive strategies essentially ignore valuations and in fact do just the opposite. As an index holding becomes more and more expensive; the index, by its very nature owns a larger percentage of that security. While it may make sense to actually sell or reduce a position that is overvalued, the index cannot sell; and in fact the index will continue to own a growing position in that company. On the other hand, as a security gets cheaper, its relative size in the indexed portfolio becomes smaller and smaller. Essentially the S&P 500 index acts like a momentum investor that buys high and sells low. There are also times when the indexes can become somewhat non-diversified due to the fact that the index is market-cap weighted. Currently the top five names in the S&P 500 index are all technology companies and comprise approximately 13.5% of the index weighting. As was the case in 2000, today we have a case of everybody being crowded into the same stocks—we suspect that will become problematic for many market participants when the market declines.

Summary

Essentially the Fed and central banks around the globe have forced investors into riskier assets such as stocks and high-yield bonds over the past eight years. We have often referred to this as T. I. N. A. (there is no alternative). For the first time since 2008, rates on the two-year treasury note have exceeded the yield on the S&P 500. Perhaps for risk averse investors, there is finally an alternative to stocks. The Fed is expected to raise rates between 2 and 4 times in 2018—this could result in an environment where T.I.N.A could finally be put to bed. While we don't believe that this will necessarily end the bull market, we do believe it makes sense for investors to become more cautious. As a "value" manager it is our job to always be cautious and to focus on risk versus return. In our opinion, investing with a "margin of safety" has never made more sense. We remain committed to owning what we believe to be high quality, undervalued equities. As Ben Graham stated in the *Intelligent Investor*, "Investing isn't about beating others at their game. It's about controlling yourself at your own game." Jolley Asset Management is approaching its twentieth anniversary. We have never wavered from our value strategy which we believe has rewarded our clients over the long term. I'm out of space now so I will refrain from commenting on the Bitcoin (cryptocurrency craze)!

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