JAM JOLLEY ASSET MANAGEMENT, LLC
A LIVE OAK PRIVATE WEALTH COMPANY

Investment Outlook

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In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497.

Warren Buffett—October 2008

With the United States in the crosshairs of COVID-19; the S&P 500 index declined by 20% in the first quarter, ending the longest bull market in history. Savita Subramanian, in the BofA Performance Monitor dated 4/02/2020, characterized the decline as "the sharpest and most indiscriminate sell-off in history." From February 19 to March 23, the U. S. stock market (S&P 500) declined by an astounding 33.9%. The S&P 500 then proceeded to rally off the lows by over 20% into quarter end, having some market pundits claiming that we have entered a new bull market. The financial media likes to label bull and bear markets by some arbitrary rise or fall, of some 20%. A quick exit from the bear phase would be somewhat of an anomaly. Bear markets that are accompanied by an economic recession tend to last approximately eleven months, according to Bank of America analysts. The damage in the broader markets was much worse than that of the S&P 500 index. For the quarter, the S&P equal weight index was down 27.7%, the S&P 400 Mid-Cap index was down by 29.7% and the Russell 2000 Index was down by 30.6%. According to Steve DeSanctis of Jefferies, it was the worst quarter on record for the Russell 2000. As was the case with small caps, this was also the worst quarter ever for value. The Russell 1000 Growth Index outperformed the Russell 1000 Value index by over 12% in the first quarter. The top-performing S&P 500 sectors were information technology (-12,2%), utilities (-14.2%), communication services (-17.2%). Technology issues typically have strong balance sheets and low debt levels compared to the rest of corporate America. The worst performing market sectors were energy (-51.1%), financials (-32.3%) and industrials (-27.4%). The S&P energy sector is currently trading at levels last seen in 2002. During the quarter, long-term treasury bonds were the best performing asset class gaining 21% and gold advanced by approximately 7%.

Index	2020 1st Qtr
DJIA	-22.7%
S&P 500	-19.6%
S&P 500 (equal weight)	-27.7%
S&P Mid Cap	-29.7%
Russell 1000/Growth	-14.1%
Russell 1000/Value	-26.7%
Russell 2000	-30.6%
NASDAQ Comp.	-14.2%

Over the past few years, we have often discussed the change in market structure. The specialist system of the New York Stock Exchange that acted as a market-maker and provided liquidity in times of market imbalances is gone. The specialist has been replaced by computers. The move to passive strategies, exchange-traded funds and algorithmic trading likely played a role in the fact that the decline was so sharp and broad based. There was essentially nowhere to hide in the market. Even high-quality electric utility stocks such as Duke Energy declined precipitously. From peak to trough, Duke Energy lost approximately 40% within a one-month time period (02/24/20 through 3/24/20). Typically, utility shares are a safe haven and also do well when we are in a declining interest rate environment. We also should keep in mind that 2019 equity market returns were exaggerated to the upside by the easy money policies of the Fed. The 31.5% return for the S&P 500 index in 2019 was largely driven by price earnings multiple expansion, rather than earnings growth. The long-term average return on stocks is approximately 10%; comprised of 6% in price change and the balance of approximately 4% coming from dividends. In 2019, the price change alone was approximately 29% or almost five times the annual average. Almost all investors, when they look at their brokerage statements, think in terms of how much the decline has been from the highs. Given that 2019 was such a strong year, perhaps one should look at current values compared to 2018 values as well. Needless to say, the pain inflicted on portfolios has been extremely painful and swift.

2020 Recession

An economic recession is defined as a period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in GDP for two successive quarters. By its very definition, one cannot conclude that we are in a recession until after the fact. Goldman Sachs is predicting that the U. S. economy will contract by 34% in the second quarter while Morgan Stanley has forecast that second quarter GDP could contract by as much as 38%. James Bullard, president of the Federal Reserve Bank of St. Louis, recently predicted that unemployment could reach 30% in the second quarter. A strong recovery is projected for the third quarter by both firms with GDP expanding in the 19-20% range. Corporate earnings are impossible to predict for 2020; there is zero visibility. In recent weeks, Wall Street analysts have sharply marked down their expectations for earnings this year. They now expect that profits for S&P 500 companies will fall 7.7 percent this year, according to data from Refinitiv. Al Root of Barron's recently projected that 2020 revenues for the S&P 500 could possibly decline by approximately 15% and earnings by 60%. Clearly there is no consensus with regards to earnings and at this point, focusing on 2020 results will likely be counterproductive. The financial markets are forward looking and typically bottom some six months before the economy actually turns. That is precisely why the markets have rallied by over 27%

from the March 23rd lows through the close on April 9th; market participants are looking to 2021 and beyond. Only time will tell if a sharp recovery in the markets is more than temporary. Much will depend on how soon we can get the economy back open for business and how small businesses will fare once they are open for business. Small business is the lifeblood of the U. S. economy and creates approximately two-thirds of net new jobs. According to a recent SBA report, small business accounts for an estimated 44% of U. S. economic activity. It is imperative for our economy that small businesses can reopen soon. This is the main driver of the Paycheck Protection Program (PPP), which is part of the CARES Act, signed into law March 27, 2020.

Government/FED Response

Let's look at the response from the government and the Fed. The CARES Act is a $2 trillion (will likely be expanded) stimulus program to put money quickly in the hands of individuals, corporations, small businesses, state and local government, public health entities and education. The Federal Reserve has taken on the "whatever it takes" approach including: essentially zero interest rates, quantitative easing (QE4), lending to securities firms, backstopping money market funds, repo operations, direct lending to banks, relaxing bank regulatory requirements, direct lending to major corporate employers, commercial paper funding facilities, direct lending to municipal governments and international swap lines. Peter Boockvar of Bleakley Advisory Group stated on April 9th, 2020, "Now outside of buying stocks, every asset class is open for the Fed to buy. They're worried about credit. Going below investment grade into the high-yield junk area is now a dangerous area they're headed to, but that'll be a discussion for another day." This past week the Fed balance sheet increased to a record of $6.13 trillion up approximately $2 trillion since year end. Bank of America analysts project it could top $9 trillion by mid-year.

Investment Thoughts

A global pandemic, social distancing, a four-week bear market followed by a 27% rebound (bull market? hopeful but not yet convinced), working remotely, the expanding Fed balance sheet, government bailouts, etc. There is too much to cover in this one *Investment Outlook*. With over forty years in the business and over thirty years managing portfolios on a discretionary basis, I cannot recall anything remotely similar to today's situation. We truly cannot accurately predict the impact of shutting down approximately one-third of the economy.

With that being said, let's look at how this translates into your investment portfolios and our strategy going forward. First, we are not market timers. We believe timing is a futile exercise and very difficult to execute. If we sell a security, we want to replace that security with a better positioned company. One with a more durable competitive position, one with a better balance sheet and/or one with less economic headwinds. We cannot be assured when the economy will reopen fully, or if this will be a V shaped recovery. In fact, we have yet to see the first corporate earnings reports, since the onset of COVID-19. While we expect investors will look past those reports, they will be horrendous for most companies. The more important question is how long will it take business to return to 2019 levels? We believe that investors will once again focus on and pay a premium for balance sheet strength, rather than chase stocks who have boosted earnings per share merely via buybacks and financial engineering. Value stocks as measured by the Russell 1000 Value index are largely pricing in a recession currently and are trading at 13.2 times earnings, 1.6 times book value and yield 3.2%. Growth issues on the other hand still trade at lofty valuation levels. The Russell 1000 Growth Index currently trades at 26.2 times earnings, 6.9 times book value and yields 1.2%, hardly what one would expect at a bear market bottom. Today's period looks similar to the 2000-2002 period, when growth issues were priced to perfection and value was already pricing in a recession and earnings downturn. Over the following three years (2000-2002) the Russell 1000 Value Index outperformed the Russell 1000 Growth Index and S&P 500 Index by 40.8%, and 23.0%, respectively. Value stocks appear cheap on both an absolute and relative basis.

Jolley Asset/Live Oak Combination

As you know, Jolley Asset Management and Live Oak Private Wealth officially joined forces on April 1, 2020. I first ventured on the Live Oak campus in August of 2017 to meet the Live Oak lending team that specializes in investment advisory loans. I was immediately awed by the feel of the campus in Wilmington and the atmosphere there. The campus has the excitement of a Silicon Valley firm and in no way has the feel of the traditional bank. Fast forward to September of 2018, when I read that Live Oak had started Live Oak Private Wealth and I must admit that I was a little jealous, and wondered why they had not contacted my firm, which had twenty plus years' experience running an RIA firm in eastern NC. Anyway, I dismissed the significance of the news, as I incorrectly assumed that it was just a typical advisory firm utilizing mutual funds and ETF's (cookie-cutter portfolios) without giving it much more thought as to the possibilities. Fast forward to 2019 where we had been exploring merging with a couple of entities and out of nowhere comes this call from Live Oak in August of 2019. After a couple of months of preliminary discussions, we put our other discussions on hold. Throughout the entire due diligence process, not once did I waiver in my belief that this was the best possible course of action for the Jolley Asset Management clients. At every point of the discussions, putting the client first was always paramount. The investment philosophy and client focus of the two firms were essentially identical. I was confident that anything that Jolley Asset Management could do alone, could be done better together with the Live Oak Private Wealth team. More investment management team depth, comprehensive wealth planning, estate and trust services all were needed to round out the Jolley Asset model. All that said, it was the people that drove the final decision. The Live Oak Bank and Live Oak Private Wealth employees are the type people I want to be associated with and finish out my career with. I look forward to introducing the Live Oak team to you and I'm sorry that COVID-19 has prevented that from happening already. Thanks again for the confidence you have placed in Jolley Asset Management—A Live Oak Private Wealth Company.

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