JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 40• Summer 2008**

> *"Thousands of experts study overbought indicators, oversold indicators, head-and-shoulder patterns, put-call ratios, the Fed's policy on money supply, foreign investment, the movement of the constellations through the heaven and the moss on the oak trees, and they can't predict markets with any useful consistency, any more than the gizzard squeezers could tell the Roman emperors when the Huns would attack."*
>
> *"One Up on Wall Street"*
> *Peter Lynch*

The second quarter began with investors hoping that the worst of the credit crunch was over and earnings growth would resume in the second half of 2008. The major indices all bounced in April and May only to continue their decline in June (worst June in 78 years according to Dow Jones). The lingering credit crisis coupled with soaring oil prices left the markets with their worst first half since 1970 and essentially testing their 52 week lows. The S&P 500 declined by 2.73% for the quarter and the Dow Jones Industrial Average by 6.93%. The S&P 500 has now declined for three consecutive quarters, which represents the longest losing streak in seven years. The average equity mutual fund was down by an average of 10.5% in the first half of 2008 according to Lipper Analytics. Growth indexes outperformed value for the quarter as evidenced by the 1.25% advance for the Russell 1000 Growth index, compared with a loss of 5.31% for the Russell Value Index. As the chart below indicates, the mid and small cap indexes fared much better than the large cap counterparts for the second quarter. Investors seeking a "safe-haven" away from the United States found there was essentially no where to hide. In fact, many foreign markets experienced huge price declines in the first half led by Shanghai (-48%), India (-33.6%), France (-21.0%) and Germany (-20.4%). The average global equity mutual fund declined by 8.2% for the second quarter versus a rise of .2% for the average domestic equity fund.

Index	2nd Quarter 2008	2008 YTD
DJIA	-6.93%	-13.27%
S&P 500	-2.73%	-11.95%
S&P Mid Cap	5.43%	-3.90%
Russell 1000/Growth	1.25%	-9.06%
Russell 1000/Value	-5.31%	-13.57%
Russell 2000	.58%	-9.37%
NASDAQ Comp.	.61%	-13.55%

In our last *"Investment Outlook—Spring 2008"*, we questioned why the media is fixated on the notion that a 20% decline is a "bear market" but a 19.5% decline is merely a "corrective phase". The following commentary from Reuters is just plain absurd, "While the blue-chip Dow Average briefly dipped into bear market territory, it managed to close above that level, thus narrowly avoiding the official onset of a bear market, or a 20% drop from its all-time high." While the National Bureau of Economic Research (NBER) officially declares if we have been in recession (two consecutive negative quarters of GDP) after the fact, there is in fact no group to officially declare a "bear market".

We have felt that this was a "bear market" since early in the year and have been managing portfolios defensively as a result. Rather than focus on some CNBC commentator, we are focusing on the following: Is the economy expanding or contracting? Are stock prices generally rising or falling (are most stocks in uptrends or downtrends)? Are market advances the result of improving fundamentals or merely "short-covering" rallies? Are global markets generally rising or falling? How is investor psychology?

> *Last quarter we stated, "Whether this is a "bear market" or "correction" is irrelevant at this juncture, but for simplicity purposes, let's go ahead and conclude that we are in a "bear market" phase. Let's also conclude that for all practical purposes, the U. S. economy is now in recession (likely started late last year)."*

We think we got the "bear market" and "recession" call essentially right, although technically the economy has not had even one quarter of negative GDP growth. While we have been concerned about the economy in recent quarters, our focus has remained on analyzing businesses that we believe offer favorable risk versus reward characteristics in the current environment. As we have stated on numerous occasions, we are not market-timers and believe that timing is a futile exercise. Mason Hawkins of Longleaf Partners stated the following about market timing in a client letter back in 1998: "We assess the probability of correctly timing the market to be less than 1 in 6. Successfully timing the market requires three sequential events—picking the market top, having a significant (i.e. 25%) decline, and picking the market bottom to reinvest. In our experience the chance of correctly predicting any of these three occurrences is less than 50%."

Avoid Momentum Stocks

During economic contractions and bear markets, most industries and sectors suffer. In fact, according to *Barron's Magazine*, currently 76% of all New York Stock Exchange issues are now trading below their 200-day moving averages. However, there will always be a few companies and sectors that are able to buck the trend (at least temporarily). As the list of companies with growing earnings and stock prices shrink, investors many times tend to pay too dearly for those few exhibiting rapid growth characteristics. Take for instance a company in the fertilizer industry, Potash Corp of Saskatchewan. Potash is a fine company—and we all know the bull case for agriculture. But we should point out that the company is now valued at approximately $66 billion, or over 12 times trailing sales, 10.7 times book value and 46 times trailing earnings. While currently they are experiencing explosive growth, we would point out that the fertilizer business is cyclical. While it may be tempting to sell stocks in the weakest performing groups in favor of equities that have done relatively well, we would resist the temptation to chase performance. We will leave this strategy for Jim Cramer and the "Mad Money Crowd".

Return of Stagflation?

Stock prices have been falling around the globe because of the outlook for four major forces: economic growth, profits growth, interest rates and inflation. Currently economic growth and profits growth are slowing while interest rates and inflation are rising. That is probably the worst of all possible combinations and reminds some of the 1970's and "stagflation". "Stagflation" is defined as a period sluggish economic growth coupled with a high rate of inflation and rising unemployment. The big question is whether profits can live up to Wall Street expectations in this period of slowing growth and rising prices. A recent polling of analysts by Thomson Reuters shows the "Street" now expect earnings to fall by 10% year over year in the second quarter. For the full year, however, they are expecting earnings growth of 7%. For 2009, analysts are calling for earnings growth of 20%. As can be seen in the chart below, energy, materials and technology are expected to show the largest profit gains in 2008. Financials continue to be the biggest drag on the earnings picture, with a 56% decline expected for the quarter just ended and a 16% decline for all of 2008. While the economy may have technically dodged a recession thus far, we would point out that there are stiff economic headwinds. Unemployment is rising, housing prices continue to fall and consumers are grappling with higher food and energy prices. In addition, foreign economies seem to have slowed recently, which could negatively impact U. S. exporters in the months ahead. In summary, it is our belief that analyst's estimates are likely too high for the second half of 2008 and for all of 2009. Once the "Street" ratchets down its estimates later this year, stocks will likely be compelling values.

Estimates for S&P Sectors

Sector	2Q '08 vs 2Q '07	Yr 2008 vs Yr 2007	Yr 2009 vs Yr 2008
Technology	16%	14%	18%
Energy	23%	32%	10%
Financial	-56%	-16%	62%
Health Care	8%	8%	11%
Industrials	6%	8%	13%
Consumer Staples	3%	3%	11%
Consumer Discretionary	-15%	5%	28%
Materials	-1%	12%	13%
Utilities	3%	7%	11%
Telecommunications	1%	0	11%
Total	-10.2%	7.3%	20.6%

Sources: Standard & Poor's and Thomson Reuters data as of June 24, 2008

Fixed Income

While the credit crunch seemed to be easing early in the second quarter, fear returned to the bond market towards the end of the quarter. Losses at large financial institutions and concerns about the solvency of bond insurers resulted in investors once again seeking safety in government debt. Despite the flight to safety, inflation fears drove yields higher. The two-year note ended the quarter yielding 2.63% compared with 1.60% at the beginning of the quarter. The yield on the ten-year note rose to 3.97% in the quarter up from 3.40% just three months earlier. We have continued to emphasize short dated U. S. Treasury notes, high quality corporate bonds and high quality municipal issues.

Summary

We realize these are challenging times for investors. While we continue to expect a difficult economic backdrop in the near term, we believe it is likely that much of the earnings slowdown has already been discounted into share prices. History has shown that recessions and the accompanying "bear market" phase typically create the most compelling investment opportunities. It remains our goal to make market volatility our friend rather than foe by using such periods as an opportunity to buy high quality companies at a more attractive level. As the late John Templeton once stated, "All my investment life, I have tried to invest at the most pessimistic time, or go against the herd mentality."

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