JAM JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook Volume 1, Issue 33• Summer 2006

Responding to Bush nomination as Federal Reserve Chairman:

"If I'm confirmed to this position, my first priority will be to maintain continuity with the policies and policy strategies established during the Greenspan years."

Ben Bernanke
Oct. 24, 2005

The markets bounced around quite a bit during the second quarter, with the S&P 500 reaching a year-to-date high in early May before sliding sharply, then recovering at the end of June to finish the quarter down (1.46%). The small-cap (Russell 2000) and mid-cap (S&P Mid-Cap 400) indexes didn't fare as well losing (5.02%) and (3.14%), respectively. Value stocks continued their dominance over growth stocks in the second quarter as evidenced by the Russell 1000 Value Index gain of .59% versus a decline of (3.90%) for the Russell 1000 Growth Index.

Index	2nd Quarter 2006	6 mos. ended 6/30/06
DJIA	.87%	5.28%
S&P 500	-1.46%	2.76%
S&P Mid Cap	-3.14%	4.24%
Russell 1000/Growth	-3.90%	-.93%
Russell 1000/Value	.59%	6.56%
Russell 2000	-5.02%	8.21%
NASDAQ Comp.	-7.17%	-1.51%

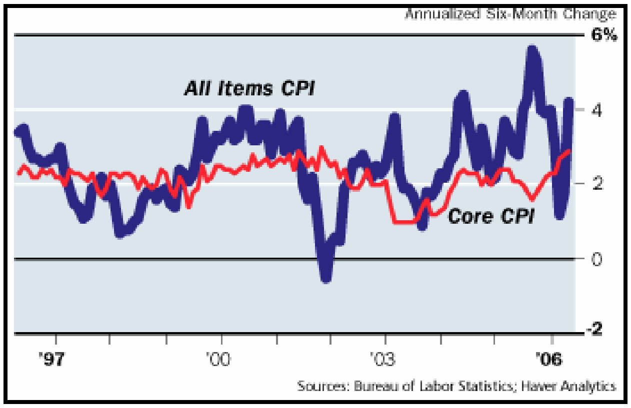
After a strong start to 2006, the equity markets closed out the first half of the year on an uncertain note. According to Michael Metz, Chief Investment Strategist of Oppenheimer, "A sudden and sharp May—June setback was largely a function of a desperate stampede by leveraged participants to raise liquidity as it became obvious that an era of extraordinary stimulative worldwide monetary conditions had come to an end." Metz also pointed out that no apparent change in fundamentals occurred, but virtually every asset class was engulfed in the liquidation phase. The domestic markets fared relatively well in the downdraft, down single digits from the May peak, while world equity markets were down close to 10% and Japan (which had been one of the stronger markets) was down by approximately 15%. Emerging markets suffered major losses from the peak, down by some 20% in dollar terms. Commodity markets were not spared in the correction, as copper dropped 25%, silver 33% and gold 25% off of their highs.

The past several weeks have certainly been a wake-up call for many market participants. For a few years now, investors seem to have taken comfort in a number of things: the global economy was strong and we had gone more than three years without a market correction of more than ten percent. Low interest rates had many investors seeking higher return opportunities. This money came from many sources, including hedge funds. These vehicles have grown in popularity and influence and in many cases their managers have been looking anywhere and everywhere for places to squeeze out some extra return. Hedge funds often use leverage and with the incredibly low interest rates we saw in 2003 and 2004 (especially in Japan where many hedge funds went to borrow), they could borrow very cheaply, then put that money to work anywhere it stood to gain more than the cost of borrowing. Corporate and high-yield bonds, as well as emerging markets securities, were likely big beneficiaries, and it's very possible that commodity futures, and maybe even REITs and small-cap stocks were a part of this strategy as well.

We can't say for certain how much of these asset classes' behavior was due to hedge funds' involvement, but we do know two things: 1) Most hedge fund managers' fees create a very strong incentive for risk-taking, and 2) according to an article in "*The Economist*" magazine, hedge funds controlled more than $1 trillion in assets as of year-end 2004, and can account for more than half the daily volume on the New York Stock Exchange (and can have an equally large presence in every other financial market). Our point here is not so much to dissect hedge funds' impact on the markets, but rather to point out that a collection of factors may have led to an increase in risk-taking in the financial markets, and it has been a few years since something came along and rattled everyone's nerves. So it is understandable that the market volatility in the last month and a half may have caught people's attention, even though the volatility was not out of line by historical standards.

Greenspan Put?

But what suddenly caused things to change? We believe that one of the reasons for the apparent liquidation by market participants was the tough talk by the Fed in May and June led many to believe the "*Greenspan put*" had been removed from the marketplace by the new Fed Chairman, Ben Bernanke. The term was coined in 1998 after the Fed lowered interest rates following the collapse of Long-Term Capital Management (a large hedge fund). The lower interest rates were thought to have "propped up" the securities markets. The "Greenspan put" was thought of as a safety net based on the assumption that Fed Chairman Alan Greenspan is ready to respond to any force that would ultimately threaten the welfare of the stock market. Market participants essentially believed that Greenspan would manipulate monetary policy and continue to maintain market stability. It is thought by many that this led to excessive risk taking by market participants and ultimately the tech bubble and the housing bubble. Recent talk out of the Federal Reserve has been less "hawkish" and time will tell if the Fed was "jawboning" the markets or truly serious about inflation fighting.



Inflation Fears

Aside from the direct damage of inflation, there is risk that the Fed will overshoot in trying to choke off inflation and that higher rates will push us into a recession. The hope among investors has been that the Fed will stop soon and the economy will slow just enough to bring inflation back within the Fed's targeted range while leaving the economy healthy enough for decent earnings growth. As economic growth has continued to surprise on the upside and the Fed has continued to raise rates, the risk of an overshoot has increasingly been on people's minds. The big question we must ask ourselves is: What are the odds that continued inflation will lead the Fed to tighten to the point that the economy ultimately tips back into recession? Given the sizeable rate increases that have already occurred and signs that the economy is slowing somewhat, our guess is that further rate increases will be limited and a near-term recession isn't too likely.

There is a potentially large laundry list of counter-inflationary forces at work right now, among the biggest of them is globalization. Not long ago, the outsourcing of jobs was the big headline and while the media has chosen to focus on other things now, we still live in a very competitive world where 1) cheap labor is readily available in most industries, and 2) it is hard to raise prices when the competition is so stiff. If jobs go overseas, domestic consumers' aggregate wages may temporarily decline; and even if producer prices (e.g., oil) experience inflation, any company with overseas competition is going to have a hard time raising prices to offset its higher costs. Their profit margins may get squeezed, but unrestrained price pass-throughs to consumers would be difficult.

Along with globalization, technology has had a big impact on productivity. Globalization and technology work together and their combined impact have played—and will continue to play—a big role in keeping inflation in check through increased productivity. The so-called "productivity miracle" is a big part of the reason why profit margins are high, even in the face of rising commodity prices and a lack of pricing power. This is a secular force that is likely to dominate a temporary cyclical rise in inflation.

Another force working against inflation is the slowdown in the housing market. The counter-inflationary impact here could take many forms. A decrease in housing prices would likely have a negative wealth effect, causing consumers to cut back on spending. Similarly, without the tailwind of rising home prices or declining interest rates, homeowners are less likely to refinance or take out home equity, again leading to lower spending. The construction and financial services industries have grown tremendously in recent years in response to the booming housing market and a slowdown could lead to layoffs; higher unemployment is usually considered recessionary, rather than inflationary. When we weigh all the evidence, we find it relatively hard to believe that a broad, dramatic, and sustained rise in inflation is likely in the foreseeable future.

Leadership Change?

It is our view that large capitalization equities are already discounting much of the inflation risk and a potential "hard landing" scenario. Looking back over the last six years, the S&P 500 index has actually declined by 3.8% while the Russell 2000 Index and S&P 400 Mid Cap index have returned 54% and 70%, respectively. In calendar year 2005, earnings for the S&P 500 grew by 22.1% while the index rose by only 4.9%. It appears safe to say, that low expectations are already built into the large cap sector of the market. Furthermore, large capitalization multinationals should begin to benefit from increased export activities, expanding foreign operations and foreign currency translation profits. Additionally, valuations are more attractive in the large cap arena. The S&P 500 index is currently trading at 15x estimated earnings versus 23x for the Russell 2000 index (small cap). Ironically, this is an exact reversal of late 1999 and early 2000, when large caps were the favored asset class. Michael Metz of Oppenheimer recently stated, "The critical variables in today's investment environment—strong balance sheets, reasonable valuations, powerful competitive positions, excess capital generation, substantial representation in foreign markets and increasing allure to activist shareholders –all favor big capitalization stocks."

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