



# Market Outlook

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**T**he stock market rebounded from the February correction on what were perceived to be dovish comments by the Federal Reserve regarding interest rate policy. The Dow Jones Industrials (+.70%), Nasdaq Composite (+.23%), and Standard & Poor's 500 (+.64%) all finished the month with small gains. Energy led sector performance on the back of a dramatic rise in oil prices with a gain of 6.1%. Financials were the worst performing sector with a loss of .86 %.

The Federal Reserve left interest rates unchanged at its March meeting, but stopped short of indicating that it would soon be lowering interest rates. To the contrary, it emphasized its concerns over inflation. Investors interpreted the comments to mean the Fed had dropped its tightening bias, and the market rally that followed recouped much of the losses from the recent correction. We think the market may be ahead of itself in this interpretation.

In Ben Bernanke's recent testimony before Congress, he expressed the Fed's view that the economy would likely reaccelerate in the second half of this year, and that the growth in consumer spending would offset the weakness in housing. He viewed the recent problems in the sub-prime housing sector as well-contained and not likely to spread. We expect the Fed intends to leave rates unchanged until it sees the core inflation rate fall within its 1-2% target. The year-over-year core CPI is currently at 2.4%.

We strongly disagree with the Fed's outlook for the economy. Economic growth is likely to continue to slow throughout the second half of the year, as the housing market continues to deteriorate and consumer spending slows dramatically. It takes roughly 18 months for a rate hike to impact economic growth, and 18 months ago the Fed Funds rate was 3.75%. This means we have yet to feel the impact of an addi-

tional 1.5% increase in short-term interest rates. The disaster in the sub-prime lending industry marks the beginning of what will be a long and steep decline both in the housing sector and in consumer spending.

The most significant factor in the economic expansion that began in 2002 has been the boom in the housing market. We can thank Alan Greenspan for this "irrational exuberance." Greenspan lowered the Fed Funds rate to 1% in 2004 after the tech bubble burst in 2000, in turn creating another bubble. Bank regulators looked the other way as the mortgage industry created a wide variety of alternative loan products enabling consumers to purchase larger homes with less money. This combination of low interest rates and loose lending standards fueled the demand for homes that drove prices higher.

The fastest growing area of the housing market over the past three years has been in the sub-prime category. A sub-prime loan is best characterized as one with little or no documentation or income verification, a high loan-to-value ratio, and very low credit scores. Sub-prime

does not necessary mean low-income. Approximately 25% of households with income over \$75,000 are classified as sub-prime on their second mortgage. We approximate that 12% of all outstanding mortgage debt falls into this sub-prime category. A second category of loan is called Alt-A. Alt-A loans have the same features as sub-prime loans, but the borrowers tend to have higher credit scores. We approximate that Alt-A loans account for another 10% of outstanding mortgage debt.

The most common feature of sub-prime and Alt-A loans is that they have short-term teaser rates that adjust upward to prevailing rates (ARM) within two to three years. Lenders based borrowers' ability to pay these loans on the teaser rates. In 2004, when the Fed

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Funds rate was just 1%, the mortgage industry saw peak origination of 3/1 ARM loans. Now the Fed Funds rate is 5.25% and the teaser rates are due to adjust upward to prevailing rates during 2007. In 2005 the mortgage industry saw peak origination of 2/28 ARM loans. These loans have teaser rates that are fixed for the first two years, and they are also due to adjust upward to prevailing rates in 2007. We think the payment shock for consumers will be unprecedented.

**W**e believe the recent problems in the weakest segment of the housing market (sub-prime) will spread over the coming months and years. In response to predatory lending practices by sub-prime lenders, many of which have declared bankruptcy, bank regulators have issued new guidance for lenders that will significantly tighten lending standards. The impact of this new guidance will not be felt by borrowers until this summer. Countrywide Financial, the nation's largest mortgage lender, estimated that 60% of today's sub-prime loan originations would not be made under the new guidance that will take effect this summer. There are nearly 4 million homes for sale today, which represent a seven-month supply, and industry experts estimate that a million additional homes could go into foreclosure as adjustable rates rise. New home completions are also near historic highs and will only add to supply. We believe home prices will see absolute price declines over the next couple of years before an extended period of flat prices as the market adjusts. We see striking similarities between today's housing bubble and the tech bubble of 2000. Seven years later, we have yet to see the Standard & Poor's 500 index surpass the high it established in 2000.

The decline in the housing market has a silver lining for stock market investors – lower core inflation and interest rates. Rental rates and owner's equivalent rent account for 38% of core inflation. The record increase in unsold homes will flood the rental market with new supply. As vacancy rates increase, home prices and rental rates will decline, lowering the outlook for the core inflation rate. Consumer spending will also slow as adjustable-rate mortgages reset, and homeowners

feel the negative wealth effect of lower home prices. A decline in the outlook for core inflation will give the Federal Reserve the opportunity to respond to the housing bubble in the same way Alan Greenspan responded to the tech bubble in 2000. We believe both short- and long-term interest rates will decline this summer as unemployment claims rise and economic growth slows to 1-2% in the second half of 2007.

The key to our bullish outlook for the stock market depends on a decline in core inflation and interest rates. Despite slower corporate earnings growth, stock price multiples can expand if core inflation and interest rates decline. The Federal Reserve must respond quickly before economic growth slows to dangerously low levels. During the mid-cycle slowdown of 1995, economic growth slowed to just 1%, but the S&P 500 rallied 40%.

We intend to increase our exposure to the fixed-income market in our model asset allocation with any temporary rise in long-term interest rates. Bond yields and the core inflation rate have tended to peak in the April/May timeframe over the past several years, and then have declined through September. As the economy slows and inflation concerns dissipate, we think long-term interest rates will decline to 4%. This will be a positive development for fixed-income investors.

There has been a significant increase in market volatility over the past three months. Increases in volatility usually lead to sector rotation, as investors reevaluate the market landscape. We think recent market volatility will mark a turning point for the consumer discretionary sector, a point at which this sector will significantly underperform. Our most significant sector overweight remains energy. Oil prices have risen from \$50/barrel in January to \$66/barrel over tensions in Iran and continued bullish supply/demand statistics. We think the alternative energy sector (wind, solar, biofuel) will be one of the most important investment themes for the next decade. As a result, we are diversifying the energy weighting in our portfolios between alternative energy companies and more traditional exploration and production companies. ■

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