



# Market Outlook

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The stock market continued to set new highs for the year, powered by huge amounts of global liquidity, merger activity, and numerous acquisitions by private equity firms. The Dow Jones Industrials (+4.3%), Nasdaq Composite (+3.1%), and Standard & Poor's 500 (+3.5%) all recorded gains for the month. Telecom was the best performing sector with a gain of 9.6%. Utilities were the worst performing sector, posting a gain of .36%.

Wall Street has no worries as the Dow Jones regularly registers new highs each day. Professional investors are taking their cue from recent stock market performance as a measure of the future prospects for the economy. The Federal Reserve Board reinforced this positive economic outlook in the minutes released this week from its May 9th meeting. It maintained its prediction of a pick-up in economic growth, stating that the downside risks to the current expansion have diminished.

The S&P 500 recovered quickly from a 6% correction in March, resulting from concerns that a weak housing market and losses in sub-prime lending would crimp consumer spending and economic growth. The consensus view continues that despite slower economic growth, problems in the housing market are now contained, and a soft landing will occur this summer, followed by a reacceleration in growth later this year. Market bulls have consistently pointed to the strength of the labor market, the low unemployment rate and strong consumer spending trends as the drivers behind continued economic expansion.

Huge amounts of global liquidity have fueled the recent rally. This liquidity is coming from an increased global money supply that is working its way into hedge funds and private equity firms. Loose credit

standards and huge amounts of leverage are being employed by these institutions to further increase their buying power. This reminds us of the loose lending standards and leverage employed by U.S. consumers that have inflated home prices over the past five years. Wall Street believes, as we do, that the spark necessary to ignite this fuel and ensure the next sustainable leg up in the bull market is an improvement in leading economic indicators. In other words, the economy must have a soft landing and reaccelerate in the second half of the year.

What concerns us is that the stock market has already priced in the soft landing and assumed it will be followed by a second-half recovery, accompanied by rate cuts by the Federal Reserve later this year. The liquidity-driven deal making that is driving stock prices is concealing the fragile state of the U.S. economy.

Perhaps Wall Street and the Federal Reserve Board should take a sobering walk down Main Street for a clearer assessment of the health of the economy, which we believe is significantly weaker than the consensus view. Economic growth for the first quarter was revised down to just .6%. We see little evidence that supports a pick-up in economic growth in the second half of this year, and there are indications that the second quarter may be weaker than the first, putting the second-half recovery at risk.

Consumer spending, which accounts for 70% of economic growth, rose 4.4% in the first quarter of 2007. This was the only positive data point in the first-quarter GDP report, other than a small contribution from state and local government spending. The trade deficit, housing market, and capital spending by corporations were all drags on economic growth. Consumer

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spending has been the life's blood of the current expansion that began in 2003, as consumers benefited from easy credit, low interest rates, tax cuts, and, most importantly, a bull market in housing. There are now indications that this credit-financed consumer spending binge is slowing dramatically.

**A** combination of rising food and energy costs is taking its toll on debt-laden consumers. Many will face increasing mortgage payments as adjustable-rate loans reset this year. We believe the negative wealth effect of home prices declining as much as 10% year-over-year will further constrict consumer spending. Some argue that rising stock prices will offset the negative wealth effect of declining home prices, but stock ownership is not as widely distributed as home ownership. Home equity is also a far more significant percentage of net worth for the majority of Americans than stock holdings. The first indication that consumers are tightening their belts came in April, when same store sales for chain stores declined by 2.3 % compared to a year ago. Wal-Mart saw its largest decline in same store sales in 27 years. Now there are indications that the labor market is not as strong as previously thought.

The Bureau of Labor Statistics (BLS) released a quarterly report this month with revised employment data for the third quarter of last year. Their original estimate of monthly job gains during the quarter totaled 498,000. This was an impressive number considering that economic growth had slowed to just 2% in that quarter. However, their revised number was shocking-the new total was just 19,000 job gains for the quarter. We have to assume that pending revisions for the last two quarters, which exhibited weaker GDP growth, will also paint a very different picture of the labor market.

There are approximately 6.8 million unemployed workers in this country out of a workforce of 150 million. The unemployment rate is just 4.5%-or is it? There are approximately 12 million illegal immigrant workers

in this country that are not included in the government employment data. Their consumption of goods and services is reflected in consumer spending data, and many have purchased homes through sub-prime lenders. We suspect a significant percentage of these workers have now lost their jobs. The monthly flow of funds from the U.S. to Mexico is half what it was one year ago. While the employment reports do not account for these job losses, the impact will be felt in consumer spending growth and the housing market.

In summary, there are no meaningful positives from the standpoint of the most important sector of the US economy—the consumer sector. With the exception of the wealthiest Americans, consumers are over-leveraged, spent out, and, in many cases, facing job losses and lower real wages. We fear that if real consumer spending declines quarter-over-quarter, the U.S. economy may report its first negative quarter of economic growth since the recession of 2001. This would clearly undermine the outlook for a second-half recovery, and a significant adjustment in stock market prices would follow. Aggressive action by the Federal Reserve would be necessary to boost investor confidence and assist in reaccelerating growth. We believe that the disconnect between the consensus view and reality is posing substantial risks to the recent market rally.

We have taken a more cautious stance with respect to our investment strategy by reducing equity exposure until upcoming data confirm the expansion is on solid ground. We have not abandoned our long-standing bullish outlook for the stock market, based on a mid-cycle slowdown in the economy, similar to slowdowns in 1985 and 1995. It is simply prudent to take precautions in the later stages of a bull market and economic expansion, especially with the emergence of new forms of leverage and speculation. We are also concerned that this Federal Reserve Board, primarily focused on inflation risks that don't exist, may not be proactive in addressing weaker economic prospects with lower interest rates. ■

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