



Market Outlook

LAWRENCE FULLER

Managing Director and Portfolio Manager

The stock market rocketed to new highs for the year as the Dow Jones surpassed the 13,000 level for the first time. The Dow Jones Industrials (+5.7%), Nasdaq Composite (+4.3%), and Standard & Poor's 500 (+4.4%) all recorded impressive gains for the month. Health-care was the best performing sector with a gain of 7.1%. Telecommunications was the worst performing sector, posting a gain of less than 1%.

We were surprised by the scale and speed of the market rally in April, following the correction in late February/early March. We believe the market needs to consolidate at current levels, and possibly see another correction, before it will move significantly higher. This does not change our bullish outlook for the stock market, but our enthusiasm has been tempered. Let us put the recent market move into perspective.

Last summer we made comparisons between what we believed was a mid-cycle slowdown in the U.S. economy and previous slowdowns in 1985 and 1995 (July 1, 2006, Market Outlook). We forecasted a significant rise in the stock market during the second half of 2006. The market began its ascent last July immediately following the last interest rate increase by the Federal Reserve. Bond yields (10-year Treasury) declined from 5.25% to 4.5%, and the S&P 500 advanced 16%. In the first quarter of this year, there was a brief acceleration in economic growth, and bond yields rose as high as 4.9%. The market was flat during the first quarter. Once it was apparent the economic slowdown had resumed in

April, bond yields declined and the S&P 500 rose an additional 4%. History tells us the market has more room to advance when we consider that the 1985 and 1995 mid-cycle slowdowns led to gains for the S&P500 of 40% on average. We believe that in order for future gains to be sustainable, some additional events must occur.

The underpinnings of the market rally that began last July were strong corporate earnings growth, declining long-term interest rates and neutral Federal Reserve policy (no more rate increases). Now that earnings growth is slowing, any additional gains will be dependent upon price/earnings multiple expansion. Stock prices can rise despite very little earnings growth if both the rate of inflation and long-term interest rates decline. Perhaps the most important factor for multiple expansion is an accommodative interest rate policy by the Federal Reserve—rate cuts! This will give the market confidence that

the economic expansion can continue. We think this will come to pass, but we have serious concerns with the Fed's optimistic economic outlook for the remainder of 2007. We don't believe it is accounting for how significant a decline we will see in consumer spending and the housing sector. If it does not address the weakening economy with lower interest rates soon, it may derail the mid-cycle slowdown and the bull market that began in 2003.

The perfect storm is about to hit the U.S. consumer. The slowdown in economic growth is in full swing, with first-quarter GDP growth coming in below

The perfect storm
is about to hit
the U.S. consumer.
The slowdown in economic
growth is in full swing...

expectations at 1.3%. This explains the decline in the rate of growth for corporate earnings. A decline in corporate earnings ultimately leads to fewer jobs and less compensation for workers as companies try to maintain profits. Downward pressure on compensation and rising unemployment lead to lower consumer confidence and less spending on goods and services. This then feeds back into slower economic growth. We believe the unemployment rate will rise for the remainder of the year and approach 5%.

The housing market decline has yet to impact consumer spending, which posted a respectable 3.8% gain in the first quarter. Countrywide Financial, the nation's largest home lender, announced a huge increase in foreclosures when it reported first quarter earnings last week. What concerned us in the report were the reasons cited for foreclosure — 64% were a result of “curtailment of income.” What happens when the unemployment rate rises from a historical low 4.4%? Less than 1% of foreclosures were a result of “payment increases.” Payment increases will start to have their full impact this summer, just as the unemployment rate begins to rise, when adjustable-rate mortgages originated in 2004 and 2005 reset with higher payments.

Additional headwinds for the consumer include a 30% rise in gasoline prices this year, the negative wealth effect from lower home prices, and the possibility of higher tax rates if Congress does not address the AMT tax that will impact an additional 20 million households in 2007. The Federal Reserve's timely response to dangerously weak economic growth in the months ahead will be critical for avoiding recession and resuming the current economic expansion.

The global engine of growth is the developing

markets, including Brazil, Russia, India and China, which now account for a larger percentage of the global economy (29%) than the United States (28%). These developing market also account for 87% of the world's population, compared to 5% for the United States. They are collectively putting upward pressure on commodity prices and downward pressure on inflation as a result of a glut of cheap labor. This is why the industrial, energy and material sectors of the U.S. market remain so strong. Normally these sectors would be underperforming as the U.S. economy entered a period of slower economic growth. Now we are depending on the developing markets to keep our economy afloat. The challenge in the months ahead will be to determine at what point foreign growth slows. If the developing economies slow before the U.S. consumer is able to regain his footing, we will have to address the possibility of a recession.

In summary, we believe U.S. economic growth will slow to 1% by the third quarter of this year, and that the rate of inflation will fall below 2%. As bond yields decline to 4% and the unemployment rate rises, the Federal Reserve will lower short-term interest rates several times in the second half of the year to reaccelerate economic growth. Despite the possibility of a year-over-year decline in corporate earnings, stock prices will rise as price/earnings multiples expand, and the S&P 500 will advance an additional 10% in the second half of the year. Our target for the S&P 500 is 1650. We see two risks to our forecast which we will be monitoring closely. The first is the possibility that economic growth in developing markets slows. The second is that the Federal Reserve does not address the imminent drag on economic growth from a significant decline in consumer spending with lower short-term interest rates. ■

Fuller Asset Management, LLC (FAM) is an SEC registered investment advisor. FAM and its representatives are in compliance with the current notice filing requirements imposed upon registered investment advisers by those states in which FAM maintains clients. FAM may only transact business in those states in which it is noticed filed, or qualifies for an exemption or exclusion from registration requirements.

This newsletter is limited to the dissemination of general information pertaining to its investment advisory/management services. Any subsequent, direct communication by FAM with a prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the prospective client resides.

For additional information about FAM, including fees and services, send for our disclosure statement as set forth on Form ADV from FAM using the contact information herein. Please read the disclosure statement carefully before you invest or send money.

©2007 Fuller Asset Management, LLC. All rights reserved.