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APRIL 2008
VOLUME 4 • NUMBER 4

Market Outlook

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We believe the financial crisis that began last summer with the demise of two Bear Stearns hedge funds ended in poetic justice two weeks ago with the failure of Bear Stearns itself. The stock market retested its January lows with the Dow Jones Industrials (-.03%), Nasdaq Composite (+.30%), and Standard & Poor's 500 (-.60%) all finishing the month relatively unchanged. Telecommunications led sector performance with a gain of 4.9%, while healthcare was the worst performing sector, posting a loss of 5.0%.

It is not money supply or the demand for credit that has plagued our financial system, but the fear our financial institutions have of losing capital, with the resulting lack of credit availability. This financial crisis may have started on Main Street, with falling home prices that triggered a steady rise in delinquencies and foreclosures resulting from loose lending standards and speculative borrowing, but the magnitude of the losses and severity of the crisis can be blamed on Wall Street.

> We believe the stock market has bottomed, will recover its losses year-to-date, and finish 2008 with double-digit returns (20% upside from current levels) based on abundant liquidity, historically low valuations, and extremely negative investor sentiment.

The near bankruptcy of investment bank Bear Stearns and the rumored demise of several other major financial institutions had little to do with mortgage delinquencies and foreclosures. These problems were the result of a crisis in confidence instigated by rumor and speculation in an effort to reap gain in the unregulated credit derivatives markets. This was a classic "run on the bank" until the Federal Reserve stepped in two weeks ago and changed the rules of the game.

In just the past few years the market for an investment tool created in the mid-90's to manage the credit risk of fixed income products grew from $900 billion in 2001 to become the largest derivatives market in the world, totaling $45 trillion today. This investment tool is called a credit default swap or CDS. A CDS is similar to an insurance policy whereby a seller or underwriter guarantees the return of principal on the value of a bond in the event of default to a purchaser for a premium. The CDS represents the value of the premium that must be paid to guarantee the bond. If the credit worthiness of a company or bond issuer is deteriorating, then the value of the credit default swap would increase, reflecting the higher cost to insure against loss. This investment tool was originally created to allow bond holders to minimize the risk of default. Over the past two years CDSs have primarily become tools to speculate on a company or bond issuer's demise, whereby the purchaser of the CDS does not own the underlying bond and seeks to gain only in the event of default or bankruptcy.

The primary sellers of credit default swaps have been commercial banks like JP Morgan, Citigroup and Bank of America. As delinquency and foreclosure rates rose last year, speculative buying of CDSs by hedge funds on the debt of lending and investment companies soared, driving up the value of these instruments. The rising value of the swaps influenced negative outlooks by rating agencies, further increasing the value of the swap. The financial institutions selling credit default swaps were forced to mark-to-market the rising value of their outstanding obligations, leading to write-downs or losses that may never materialize. These paper losses effectively reduced the capital held

by our major lending institutions necessary to create credit, despite the fact the Fed was lowering interest rates. We believe this unregulated market is the root cause of the credit crisis.

The Federal Reserve intentionally disrupted speculation in the CDS market by negotiating the bailout of Bear Stearns by JP Morgan, effectively wiping out the rising value of credit default swaps on Bear Stearns' debt that were purchased by those betting on the firm's demise and eliminating the obligation of the underwriters (perhaps JP Morgan). In addition, the Federal Reserve launched a new $200 billion lending facility open for the first time to investment banks in exchange for troubled mortgage-backed securities. These actions were designed to reduce credit risk, improve credit availability and send a message to speculators. A decline in credit risk will lead to a decline in the value of credit default swaps. As a credit default swap loses value it reduces the mark-to-market paper losses for the sellers and improves their capital position. The increase in capital then improves credit availability. We see little potential for actual losses in the financial system approaching anything close to current expectations, especially when the disseminators of these apocalyptic forecasts were clueless about the mortgage meltdown when it began a year ago.

The majority of economists and the public at large are convinced the U.S. is in recession. We do not agree. Unemployment claims and layoff announcements are running well below previous recessionary levels, and consumer spending is on track to post a small increase for the first quarter. The improvement in trade, due to a weak dollar and the benefit of inventory rebuilding, will lift economic growth, which we see being closer to 1% for the first quarter of this year. We believe the sudden realization that the economy continued to grow, despite the financial crisis, will be an important catalyst for the stock market recovery.

Other events we see in the months ahead underpinning a market rally are a decline in commodity prices, a firming of the U.S. dollar, rate cuts from the European Central Bank (ECB) and a decline in the rate of inflation that eases concerns of stagflation.

Commodity prices have soared this year as the financial crisis intensified, despite recession forecasts in the U.S. and slowing economic growth around the world. We believe this rise was a direct result of a flight from stocks and bonds and a weakening of the U.S. dollar. We see a correction in commodity prices ahead that will firm up the value of the dollar. Any strength in the dollar will further accelerate the unwinding of speculative positions in commodities.

Inflation fears coupled with slowing economic growth (stagflation) have limited any upside in stock prices. We believe the rate of inflation peaked earlier this year, and that a correction in commodity prices will further alleviate inflation concerns in the months ahead. Lower inflation readings will allow the ECB to join the Federal Reserve in cutting interest rates in an effort to combat weak European economic growth. This will also have the effect of strengthening the U.S. dollar, which in turn will put downward pressure on commodity prices and crude oil in particular. This interrelationship between commodity prices, the dollar and inflation are critical to our bullish outlook.

We believe the stock market has bottomed, will recover its losses year-to-date, and finish 2008 with double-digit returns (20% upside from current levels) based on abundant liquidity, historically low valuations, and extremely negative investor sentiment. As the financial crisis fades and the enormous amounts of monetary and fiscal stimulus work their way through the economy, the hoards of cash on the sidelines will move back into the stock market in the months ahead. ■

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