



Market Outlook

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In early February, we concluded that the record levels of cash socked away in money market funds, earning a negligible rate of return, would eventually lead to an unannounced surge in asset prices as violent and substantial as the decline that followed Lehman Brothers' bankruptcy and the collapse of credit markets last September. The stock market (S&P 500) has now soared 48% from the low established in March, yet skeptics still abound as money market fund balances remain twice their historical average relative to the value of the market. We believe this bull stampede is far from over. The Dow Jones Industrial (+8.6%), Standard & Poor's 500 (+7.4%) and Nasdaq Composite (+7.8%) continued their ascent in the month of July. Materials led sector performance with a gain of 13.3%, while utilities were the worst performing sector, posting a gain of less than 4% (source: Bloomberg.com).

We view the dramatic rise in stock and bond prices as nothing other than an unwinding of the panic-driven liquidation of investments that began last fall. The market is climbing back to these levels on the realization that our banks were never insolvent, that the depression was actually a recession and that life isn't coming to an end as we know it! These remarkable gains have been achieved on the basis that bad news is good news when it is less bad than expected. It should come as no surprise that the market bottomed coincident with the point of deepest contraction in economic activity, because markets bottom when the fundamentals can't look any worse. We have continually focused on the rate of change in the data points that measure economic health, rather than the absolute numbers that are spun to project the worst possible outlook. It is the rate of change, and the direction of that change, that matter most to the financial markets. A loss of 200,000 jobs is good

news when the economy was losing twice that figure in the previous month. What will fuel the demand for stocks in the months ahead is a continuation of the improvement in economic indicators and a resurgence in corporate earnings that defies an overly cautious consensus view.

In May we noted the sequential improvement in the global Purchasing Managers Index (PMI) for manufacturing and services companies, which precedes an upturn in industrial production. Orders must be placed for goods and services by purchasing managers before they can be filled by the companies that produce them. Since then we have seen a rise in

business and consumer confidence, a steady decline in layoff announcements and unemployment claims, and the first signs that home prices have found a floor. The economy is now on the verge of a staggering rise in industrial production to rebuild the record plunge in inventories. This will lead to increased spending on capital equipment, advertising, travel and most importantly, job creation. The economy is finally expanding again after four consecutive quarters of contraction.

We anticipate corporate earnings will exceed expectations in the third quarter, despite what may be tepid revenue growth, because costs have been cut so dramati-

cally. Companies are as slow to rehire workers and increase spending in a recovery as they are to cut costs during a recession. This leads to an acceleration in profits that outpaces the rise in revenues when business improves. We are on the cusp of a positive feedback loop that should continue to propel asset prices higher. As asset prices have risen, so has confidence. An improvement in consumer and business confidence leads to an increase in spending and economic growth. Economic growth ultimately leads to job creation, and asset prices forge higher. But what will sustain the recovery

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beyond an upturn in the inventory cycle, and how will we compensate for years of consumption-led growth when the government stimulus is gone and the savings rate continues to rise as Americans repair their balance sheets?

We believe a continuing improvement in our trade deficit over the next several years will offset the decline in economic growth likely to result from a reduction in household consumption. China is now the engine of global growth and its recovery has been robust. This growth is driving V-shaped recoveries in many other export-oriented developing countries. A middle class is emerging within the developing world. As this newborn middle class inevitably consumes more of the goods and services we take for granted, our exports should continue to improve relative to our imports. This gradual improvement in the trade deficit, which began in 2007, should offset a significant percentage of the anticipated decline in domestic consumption, and be an additional source of job growth. For this reason, we do not fear the so-called "death of the consumer" or a rise in the savings rate, but embrace it as an opportunity to repair America's balance sheet and rebuild the engine for future economic growth in our country.

Critical to this endeavor will be breaking our dependence on consumption for economic growth and refocusing it on innovation. We can start by ending policies that are penny wise and pound foolish, and begin thinking beyond today and tomorrow in our search for solutions. A program like "Cash for Clunkers" is a step in the wrong direction. This program was funded with \$1 billion to provide consumers with as much as a \$4,500 rebate when they purchase or lease a fuel-efficient vehicle (+22 mpg), provided they trade one in that is less fuel-efficient (-18 mpg) so it can be destroyed. The amount of energy consumed and pollution created to build the new vehicle completely negates the fuel-efficiency benefits of driving it when it leads to the destruction of an older vehicle that was perfectly viable for continued use. The program was intended to last until November, but the authorized funds were exhausted within five days. Congress is moving

quickly to approve an additional \$2 billion by shifting funds away from a renewable energy loan program. This \$3 billion would amount to more than the total appropriated for advanced car battery systems and electric vehicle technologies in the economic stimulus package. This is not the type of stimulus that will lead to sustainable growth, because it reinforces our dependence on consumption, and typifies the fiscal mismanagement of resources that assures we continue to cede leadership in new energy technology.

Despite these setbacks, we remain optimistic about the remainder of this year. The reason China's recovery has been far more robust than ours to date is because their stimulus is focused almost exclusively on the types of investments we have yet to make. The majority of what we have spent has been dedicated to transfer payments and tax cuts. As the rebuilding of inventories runs its course through the remainder of this year, we expect the investment portion of the stimulus plan dedicated to energy and infrastructure to pick up the slack. We believe the economy will expand 3-4% in 2010 as a result. This should lead to substantial revenue growth for well-positioned companies in the technology, industrial, material and energy sectors, but our favorite remains the financials.

The bank index has produced twice the return of the stock market since the March low, but the group still remains inexpensive. The benefit that banks have over other industries is that they do not need to grow revenues in order to grow earnings. All they need is the eventual and inevitable decline in loan losses and an earnings explosion will follow. As we continue to see gradual improvement in the employment and housing data, the rate of delinquencies and foreclosures will decline, and the realized losses on loans and provisions for future losses will dissipate. Loan losses consumed 75% of industry revenues in the first quarter of 2009. Should losses decline to 25% and revenues remain level, profits will triple. We believe the financials will lead sector performance through the remainder of the year and provide the rest of the market with a tailwind to help reach our 1200 target for the S&P 500. ■

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