



Market Outlook

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Bulls successfully defended what we defined in July as an important support level (1000) for the S&P 500 index, and the surge in stock prices that followed led to the best monthly performance in more than a year. The Dow Jones Industrials (+7.0%), Standard & Poor's 500 (+6.9%) and Nasdaq Composite (+6.9%) all finished with significant gains. Materials led sector performance with a gain of 12.2%, while healthcare was the worst performing sector, posting a gain of just 1.2% (source:Bloomberg.com).

We believe the macroeconomic malaise experienced in recent months, as quantified by the initial estimate that economic growth advanced at an annualized rate of just 2.4% in the second quarter, will soon be behind us as growth reaccelerates this fall. It would be easy to jump on the bandwagon of slow growth, endlessly low interest rates and sub-par equity returns, coined “the New Normal” by popular pundits, but that’s not the way we see it. We found the GDP report encouraging. The greatest detractor from economic growth was trade, with the deficit subtracting 2.8% from the growth rate, but not because our exports plunged. To the contrary, exports have surged more than 20% in the past year, but imports are growing at a faster rate and off of a larger base number. The surge in imports is indicative of a strengthening domestic economy. We also found encouragement in that corporate spending increased at a 17% annual rate, helping boost overall growth relative to the modest increase in consumer spending. But those questioning the strength of the economy, seemingly hoping for failure, continue to point to tepid job growth. Despite six consecutive months of private sector job creation, the numbers have been less than we expected, perplexing considering the improvement in other indicators.

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Our best guess is that politics is playing a key role. The Obama administration and the Democrats that control Congress have declared war on corporate America, or at least that is the way it is being perceived by corporate America. Is it out of the question to suspect that corporate America may be fighting back by doing what it can to stall the improvement in payrolls leading up to a pivotal mid-term election, under the guise that the future remains “unusually uncertain”? The punishment for such inaction, in terms of new hires, would be nothing more than another quarter of improved productivity. Even if our conspiracy theory proves inaccurate, the balance of power is very likely to shift come November, leading to divided government and neutralizing many of the anti-business initiatives underway in Washington. We believe such an outcome will boost corporate confidence and lead to a measurable increase in the monthly gains we have seen in payroll employment to date.

Another conundrum facing bulls is the dramatic decline in Treasury yields to record low levels this year, and the message similar declines have sent to investors in the past—anemic growth, deflationary risks and minimal investment returns. We must admit that our forecast for interest rates this year has been completely inaccurate, given our sense that yields would rise instead of fall as the economy recovered, but we think the mechanics behind the decline are obvious and not indicative of what the bears suggest. Financial institutions in the U.S. purchased large quantities of Treasury debt last year, along with the Federal Reserve, due to slack loan demand and in an effort to increase “quality” capital holdings in advance of the stress tests. We think it was no coincidence that the decline in yields this year coincided with the unfolding of the sovereign debt crisis in Europe. We suspect that

European financial institutions also increased their Treasury holdings, in lieu of sovereign debt, and in advance of similar stress tests, the results of which were reported last week. As loan demand recovers, employment growth accelerates and the strains in European financial markets ease, the forces driving yields lower will abate. For the time being, we view this particular barometer of future economic growth as having been broken.

We are encouraged by developments in international markets. Efforts to slow growth in China have ended abruptly, and we think the PRC will implement measures to stimulate the economy in the months ahead. We believe the Shanghai Composite, having declined as much as 32% from its 2009 highs, has bottomed. The rally in recent weeks leads us to the conclusion that a soft landing will take place, and that growth will reaccelerate by year-end, leading to significant gains in the benchmark index as a new bull market begins. Such events, should they transpire, would be a boon to the developing world, offsetting to some degree the anemic growth in Europe and further supporting U.S. economic growth.

If it sounds like we are striking a more bullish tone than last month, we are. The money supply (M1), which has been flat for nearly six months, broke out to the upside last month to reach a new cycle high. This tells us loan demand is starting to rise again. GE raised its quarterly dividend by 20%. Federal Express raised its profit forecast for the year ahead and announced it would fully reinstate its company match for 401(k) plan participants. The American Bankers Association reported that credit card delinquencies fell to an eight-year low in the first quarter of 2010. These developments speak volumes about what lies ahead in terms of economic activity and confidence, both of which are improving, and are not indicative of a looming recession or even a deteriorating outlook.

We recognize that consumer sentiment is dismal today, but is that really a bad thing for investors? The University of Michigan has reported results for its consumer sentiment survey each month since 1978. When the results of the monthly surveys are ranked in deciles from the most

pessimistic level of sentiment (last decile) to the most optimistic (first decile), recent results fall in the next to last decile. Perhaps ironic to most investors, when consumer sentiment has fallen into one of the bottom three deciles, the performance for the S&P 500 in the subsequent five-year period has been an annualized 12%. When sentiment rose to the top decile, implying extraordinary optimism, subsequent five-year period returns were actually negative! Statistics like these are powerful tools when forecasting because they often lead to conclusions that run counter to consensus thinking.

An even more stunning and timely statistic is one that highlights the impact of mid-term elections on stock market performance, regardless of the election outcome. There have been 15 one-year periods since 1950 that began on October 1 in the second year of a presidential term. The S&P 500 has posted positive returns in every period. The average gain has amounted to nearly 25%. Perhaps this time it will be different, but when we combine the recent dismal consumer sentiment survey results with the mid-term elections approaching during the second year of a presidential term, we feel we have a very strong historical tailwind supporting our bullish outlook for the market.

The stock market bottomed in March 2009 just before leading economic indicators began to rise. The recession officially ended just three months later. The market soared as a stimulus-induced recovery unfolded over the preceding 12-month period, stalling on April 23rd of this year. As the economy is transitioning from recovery to expansion and the engine of economic growth is shifting from the public sector to the private sector, we are in the midst of a correction in stock prices and a slowing in the rate of economic growth. This is very consistent with the historical playbook. We expect the market (S&P 500) to remain range-bound between 1050 and 1150 through the remainder of the current quarter, providing investors the opportunity to position for what we believe will be a breakout to the upside that will challenge the April highs before year-end. Our fair value estimate for the S&P 500 remains 1350. ■

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