



# Market Outlook

## LAWRENCE FULLER

Managing Director and Portfolio Manager

The stock market resumed its ascent in November with the Dow Jones Industrials (+6.5%), Standard & Poor's 500 (+5.7%) and Nasdaq Composite (+4.9%) all registering gains for the month and new highs for the year. Materials led sector performance with a gain of 11.3%, while the energy sector was the worst performer, posting a gain of just 2.8% (source: Bloomberg.com). Bulls and bears are engaged in an intellectual tug of war over the mixed messages financial markets are sending as the value of the U.S. dollar plunges to multi-decade lows and the price of gold soars to all-time highs, while Treasury yields decline to levels not seen since the financial crisis. What do these developments tell us about the probable direction of interest rates and asset prices in 2010?

The U.S. dollar has been gradually eroding in value relative to the currencies of other developed countries ever since our budget surpluses turned to deficits nearly eight years ago. Our economic growth has been slow, debt-induced and accompanied by relatively low interest rates. The dollar's long-term decline can be attributed to foreign capital withdrawing from our market and flowing to other markets that exhibit higher rates of growth and return. The major risks a weakening dollar present are that foreigners may no longer choose to fund our deficits by purchasing Treasury debt, and that the prices paid for the goods and services we import could increase. Both have the potential to cause a rise in interest rates and the rate of inflation that would further hamper economic growth. For these reasons, the federal government always purports to have a "strong dollar" policy, regardless of its economic agenda. Yet as the dollar has depreciated, inflation remains subdued, interest rates are near historic lows and foreign demand for Treasury debt remains strong.

Currency traders have more influence on the dollar's value in the short rather than long term. We believe the dollar's rapid decline this year can best be explained by the Federal Reserve's interest rate policy. A currency's yield is determined by short-term interest rates, and once the Fed lowered this rate to zero at the end of last year, there was little incentive for traders to hold the U.S. dollar. Dollars have been sold in exchange for foreign currencies that carry a higher yield in order to earn the interest rate differential on what is called the "carry trade." Today, one could sell a U.S. dollar yielding practically zero and purchase an Australian dollar yielding more than 3%. The Fed has informed investors that it intends to keep interest rates low for an "extended period of time," which has only served to reinforce the carry trade and place more downward pressure on the dollar. The Fed did emphasize that the extended period could be cut short by a rise in inflation expectations or a decline in the unemployment rate.

We believe financials will reestablish their leadership position as we enter the new year and continue to view the energy, industrial, materials and technology sectors favorably on the basis that the global economic expansion will continue well into 2010.

The bears have argued that the carry trade is brewing a new asset bubble in financial markets on the premise that speculators are leveraging their currency exchange bets by borrowing dollars at low interest rates to invest in stocks, bonds and commodities. This did occur in years past, with the Japanese yen serving as the funding currency, enabled by Japan's central bank rates hovering near levels similar those in the U.S. today. Fueling the bear's fear is the striking inverse correlation between the dollar and other financial asset classes. When the dollar falls, we see stocks, bonds and commodities rise in value, and when the dollar rises, they fall in value. The hole in this argument is that the loans which would be outstanding to fund this leverage don't exist. We believe this to be more of a behavioral response by traders over fear that the influence a leveraged carry trade might present, rather than its

actual existence. We believe that it is this fear that has led to a surge in the price of gold. The public's insatiable appetite for the yellow metal reminds us of the euphoria that accompanied oil's rise to \$146/barrel in the summer of 2008. A strengthening of the dollar that should coincide with the continuation of the economic expansion could spell trouble for the gold trade.

**W**hile the negative aspects of a weak dollar have been center stage recently, there are significant benefits that we believe the Federal Reserve is welcoming, if not encouraging, with its current monetary policy, in light of our need to source economic growth beyond consumption. American companies are far more competitive in the global economy as the dollar weakens, because the goods and services we export become less expensive in foreign markets. The U.S. now exports more to developing economies than it does to developed ones, which is a trend that should continue, given that developing economies are leading the recovery. This has resulted in a surge in corporate profits. These profits ultimately lead to increases in employment and capital expenditures. This improvement in competitiveness is also encouraging an increase in foreign investment in the U.S. manufacturing sector, which in turn creates jobs and further improves our trade deficit. For these reasons we should be welcoming a weak dollar as the economy recovers, but ultimately anticipating its recovery at the same time. We believe a reversal in the dollar's slide will ensue next year as the U.S. economy begins to create jobs and the Fed slowly begins to tighten monetary policy.

The decline in bond yields, Treasury yields in particular, has led to spectacular returns for bond funds this year. Individual investors have shunned stock funds, despite the historic rally, in lieu of income alternatives to the puny yields offered by money markets. We attribute the decline in Treasury yields to the unprecedented securities purchases made by both the Federal Reserve and the money-center banks. The Fed initiated a program in March to purchase \$300 billion of Treasury debt and \$1.25 trillion of mortgage-

backed securities in an effort to keep interest rates artificially low and flood the banking system with liquidity. The objective was to encourage banks to lend, but up to this point they have been investing this cash in government bonds. Why? The government has imposed draconian capital requirements on the banks, which they must maintain if not increase, in order to repay the loans they received earlier in the year. Every new loan they make requires additional capital. Why make loans when a significant profit can be realized on a government bond that requires no additional capital so long as short-term interest rates are near zero. The percentage of bank balance sheets held in Treasuries has reached historically high levels.

The Fed recently completed its Treasury purchase program and will have fulfilled its target for mortgage-backed securities by next March. As loan demand recovers next year and lending standards begin to ease, the banks that are purchasing Treasuries today will likely be net sellers tomorrow. The absence of this demand and ultimate rise in short-term interest rates from levels that can't go any lower will lead to an increase in bond yields, limiting the upside returns to bond funds that the public appears to be chasing today. We suppose interest rates could continue to decline from here, the dollar could spiral significantly lower and gold could soar another few hundred dollars, but we think a contrarian move on all three fronts is more likely.

The stock market has made a series of higher highs and higher lows since the bull market began in March. Until we see the market break below a previous low, we see little need for concern, and view each pullback as an opportunity to invest. Our upside target for the S&P 500 remains 1200. From a sector positioning standpoint, we believe it is prudent to underweight consumer discretionary stocks moving forward, and continue to underweight the healthcare, utility and staples sectors. We believe financials will reestablish their leadership position as we enter the new year and continue to view the energy, industrial, materials and technology sectors favorably on the basis that the global economic expansion will continue well into 2010. ■

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