



Market Outlook

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The stock market finished the month of January at the lower end of a trading range established approximately 8% above the bear market lows reached last November, as Congress deliberates the size and structure of the economic recovery plan and the Obama administration determines how best to deploy the second \$350 billion from the Troubled Asset Relief Program (TARP) to revive credit markets. The Dow Jones Industrials (-8.8%), Standard & Poor's 500 (-8.5%) and Nasdaq Composite (-6.2%) all suffered significant losses (source: Google finance).

Financials led the market decline in January based on the belief that the entire system is insolvent. Recent share price declines along with fourth-quarter earnings reports would seem to validate this assessment. Despite historic efforts by the Federal Reserve to lower interest rates and increase money supply, the banks refuse to lend. The decision made by former Treasury Secretary Paulson to inject capital from the TARP into banks has been a complete disaster. We were told the money would be used to lend to consumers and businesses, thereby unclogging credit markets, but it has instead been used to meet what can best be described as margin calls on the declining value of "troubled assets" – the same troubled assets that the TARP was designed to buy. These so-called troubled, toxic or bad assets are loans extended to consumers and businesses prior to the recession that sit on the balance sheets of financial institutions.

We believe the banking system has ample capital and is not insolvent, but every quarter the banks are forced to value or "mark" the loans they hold on their balance sheets as if they were selling them in the market on that day (mark-to-

market). Irrespective of whether these loans are performing or not, in an illiquid market laden with tremendous fear and absent any willing buyers, their market value is steeply discounted from fair value or value at maturity. This decline in market value is considered a loss of capital on the balance sheet of the financial institution, and in turn requires maintaining more liquidity as well as reducing lending capacity. As long as financial companies fear lower marks on their assets, they will continue to restrict credit availability and use cash infusions to build reserve capital.

We believe the recession will end during the course of 2009. It is likely that markets will begin to recover in advance (3-6 months) of an economic recovery.

We have confidence that Treasury Secretary Timothy Geithner will be more effective than his predecessor in deploying the second \$350 billion of TARP funds by creating a market for troubled assets and addressing the root cause of their trouble – foreclosures. Purchasing debt either through a "bad bank" like the Resolution Trust Corp. or other entity accomplishes two goals. It creates a rational market for these assets that will likely attract private capital and it allows the government to renegotiate the terms

on the loans they own to mitigate foreclosures. The actual process of doing this is far more complex than just described, but the initiation of such a program will breed something the markets are starving for – confidence! A change in sentiment can be a self-fulfilling prophecy. If banks see an improvement in the value of the assets they retain, and if they believe government programs are in place to mitigate the rise in loan delinquencies and foreclosures, we think they will begin restore credit availability.

The market is likely to remain range-bound until the passage of an economic stimulus package in coming days, and the potential for an economic and market recovery will

depend upon its size and structure. Democrats and Republicans are debating the balance between tax cuts and spending initiatives that will have the greatest multiplier effect along ideological lines as usual, while some would prefer no government involvement at all. Unfortunately, the free market is no longer the arbiter of economic activity. That role is now held by the federal government.

From our perspective, the stimulus must restore confidence in the short-term by addressing state budget deficits and the needs of some 13 million under- and unemployed, but it must also address the structural changes to the U.S. economy necessary to foster long-term economic growth. We are at the end of an era in terms of relying on asset appreciation and debt-induced consumption to drive economic growth. Reducing tax rates at a time we need to borrow money to stimulate growth would be as irresponsible as it was when we initiated wars in Iraq and Afghanistan. We are hopeful that any revision to tax policy comes in the form of credits designed to foster the investment we need to create jobs.

The majority of unemployed come from the construction industry. The Obama administration proposes tapping this pool of ready labor to rebuild our roads, bridges, schools and other infrastructure projects. Yet sustained economic growth is dependent on advances in productivity and efficiency that will require new investments in energy, health-care and education. We believe the greatest investment opportunities will be found in initiatives to overhaul the nation's electricity grid in ways that promote renewable energy and reduce America's dependence on foreign oil.

Hubbard's Peak will eventually converge with Moore's Law in the years ahead. Despite the recent fall in oil prices, we believe demand will gradually recover and production will continue to decline. At the same time, we continue to see technological advancements in the amount of energy produced from wind, solar and other renewable sources. We

see a coming of age for alternative energy with the establishment of a national Renewable Portfolio Standard (RPS) by the Obama administration similar to the one that already exists in California. As we debate the merits and costs of these initiatives, the oil-rich United Arab Emirates is pouring billions of dollars made in oil into alternative energy, with the intention of maintaining its dominant position as a global energy supplier.

We believe the recession will end during the course of 2009. It is likely that markets will begin to recover in advance (3-6 months) of an economic recovery. Improvements in employment, consumer spending and home prices have not been leading indicators to market performance in past recessions. In the early 1990's, the stock market bottomed nearly one year before home prices bottomed. Those indicators that historically lead a market recovery are all improving. Central banks around the world are cutting short-term interest rates, money supply is exploding and credit spreads are narrowing. Home prices have declined 25% from their peak in 2006 and continue to fall, but we believe they will bottom in the months ahead. Home price affordability is approaching a record high and the relationship between home prices and median family income is near its historical norm. Yet we will need to see an improvement in credit markets before consumers are able to capitalize on the record decline in mortgage rates.

We live in an age that demands immediate satisfaction, where patience is a lost virtue, especially for those that have seen a significant percentage of their net worth disappear. The internet age has accelerated the speed at which information flows and markets move around the world. Money-market funds are at a historical high relative to the value of the stock market. We do not know what event will ignite this liquidity and reflate asset prices in the year ahead, but we do believe it will occur unannounced and that it will be as violent and substantial as the decline that occurred following the bankruptcy of Lehman Brothers in September of last year. ■

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