



Market Outlook

LAWRENCE FULLER

Managing Director and Portfolio Manager

We decided to depart from our typical format this month to address the President directly in an effort to shed light on what we believe to be the greatest risk facing our country and our financial markets through the remainder of his first term in office. The Dow Jones Industrials (-3.5%), Standard & Poor's 500 (-3.7%) and Nasdaq Composite (-5.4%) all finished lower for the month. Healthcare led sector performance with a gain of less than 1%, while the telecom sector was the worst performer, posting a loss of more than 9%.

Dear President Obama,

It was because of your sound reason and centrist views as a candidate that independent voters accepted you as a viable alternative to the status quo.

Yet in recent months your policy agenda has taken a sharp left-hand turn off the road we believe leads to a sustainable economic recovery—a road that divides the two opposing and dysfunctional ideologies that plague Congress. Voters in Massachusetts made this abundantly clear in a special election last month which could be interpreted as a demand that you reprioritize your agenda. Your response has been to push a more populist message that Democrats hope to be politically advantageous

come November, but we view this as imprudent.

We endorsed your \$787 billion stimulus plan last February because we believed it would focus on the investments necessary to transform our economy and lead to economic growth that would create jobs. What we have seen up to this point is predominately transfer payments, entitlement spending and tax benefits intended to induce consumption-based growth. According to your website (recovery.gov), only \$58

billion of the \$275 billion in stimulus funds set aside for the grants, loans and contracts that create jobs has been paid out. Could this be one reason that the public is frustrated?

Ultimately, you must use your powers of persuasion to convince the public that we must raise taxes, reduce spending and embrace pro-growth policies in a way that expands the economy in order to avert another financial crisis.

Your healthcare reform efforts, while well intentioned, did not succeed because you chose to focus on coverage before addressing cost containment. Forcing insurance companies to provide coverage for all, while

reducing government reimbursement rates, would lead healthcare providers to negotiate higher rates with managed care companies. The higher rates would then be passed on to the insured as higher premiums. The uncertainty surrounding such significant changes is more than Americans are willing to accept during difficult economic times. Our greater concern should be how we can continue to pay costs that are rising at more than double the rate of

inflation. The cost shifting that would likely occur under proposed reforms does not address this central issue, and the continued uncertainty only serves as a headwind to economic expansion.

Your administration's response to growing public frustration has been to enflame the public's outrage over the bailout on Wall Street. Meaningful financial reform that will prevent a future crisis has little to do with dictating salaries and bonuses or imposing a tax on bank liabilities to recoup losses from the bailout.

Perhaps it is good politics, but it reeks of hypocrisy that further undermines the public's trust of government and thwarts the potential for progress. It is more than disingenuous to question compensation practices after approving \$6 million pay packages for the CEOs of Fannie Mae and Freddie Mac this year and last, especially when the Congressional Budget Office estimates the total cost

to taxpayers for the government takeover of both companies will be \$389 billion. Proposing that the largest banks pay a fee to cover the projected \$68 billion loss likely to result from bailing out AIG and the auto industry is equally as glib when these banks have all repaid the loans they were forced to take, with interest. Any reforms that serve to limit the responsible creation of capital and credit availability, as popular as they may be with the public, will only serve to slow economic growth and undermine your agenda.

It would behoove you to recognize that we require as robust a recovery on Wall Street now as we hope to see on Main Street in the near future in order to maintain the high levels of economic growth needed to avert the looming fiscal

crisis that lies ahead. Our \$14+ trillion economy is saddled with more than \$12 trillion in national debt. Your 2010 budget proposal totaling \$3.8 trillion, which is expected to approximate 25% of GDP, is touted by your economic team as similar to President Reagan's 1983 budget, which also followed a recession and his first year in office. That budget totaled nearly 24% of GDP. The critical difference is that the national debt then stood at less than 40% of GDP, not the 85% that

it is today. We spent more on interest payments last year (\$200 billion) than it cost to finance the wars in Iraq and Afghanistan in what was a historically low interest rate environment.

Based on Congressional Budget Office projections for the deficit over the next three years, even if we assume a 5% nominal rate of economic growth (GDP) and no increase in interest payments, the debt-to-GDP ratio will approach 100%. History

tells us that such a debt ratio slows economic growth substantially, resulting in a further decline in tax revenue that increases the deficit. Rising debt levels inevitably result in higher borrowing costs as creditors demand to be compensated for the additional risk. The tipping point comes when the interest on our debt as a percentage of GDP exceeds the nominal rate of economic growth, forcing abrupt and draconian cuts in entitlement programs and national defense. Should the Federal Reserve be forced to purchase the additional Treasury debt necessary to defer cuts in spending, the money supply would explode, calling into question the dollar's standing as the world's reserve currency and potentially leading to a prolonged period of hyper-inflation.

You can be sure that Republicans in Congress will

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continue to push for tax cuts, while Democrats insist on more spending initiatives, in a continuation of the status quo that led to this debacle. Ultimately, you must use your powers of persuasion to convince the public that we must raise taxes, reduce spending and embrace pro-growth policies in a way that expands the economy in order to avert another financial crisis. Members of Congress are delusional, and left to their own devices neither side of the aisle will materially reduce the deficit until another crisis unfolds.

We are not forecasting Armageddon in the near future. To the contrary, we are in the midst of a robust global expansion as evidenced by the initial estimate that the economy grew at a real rate of 5.7% last quarter. Consumer confidence rose to a 16-month high as home prices continue to rise and financial markets recover. The inventory rebuilding that contributed 3.4% to economic growth is likely to continue through year-end. As corporate profits have risen dramatically, capital spending is on the rise, and increases in employment will undoubtedly follow. We implore you to promote pro-growth policies in the year ahead that fuel increases in trade and capital investment. This is our only recourse given the limited ability of the American consumer to spend.

As we have clearly outlined, the greatest risk to the continuation of the bull market is a political one. We believe the recent correction in stock prices had more

to do with the tightening of monetary policy in developing markets than your policy initiatives, but this could change as the year progresses. For the moment, we are maintaining our optimism and believe the U.S. stock market will lead in terms of global performance. Where we see substantial risk near term is in the bond market, given our view that interest rates will gradually rise, reflecting stronger rates of economic growth and the risk our mounting deficits pose longer term.

Your first investment recommendation as President came on March 4, 2009, and it was a prudent one, suggesting that it might be a smart time to buy stocks. That was one week prior to the lows, but the public didn't listen. We encourage you to reiterate your recommendation. Investors' insatiable appetite for bond funds in recent months at what we believe to be the bottom of the interest rate cycle is misguided. Even more so is the latest investment strategy to surface in the world of pension funds. The State of Wisconsin Investment Board, which manages \$78 billion, recently approved the adoption of a strategy to leverage its safest investments (government and investment grade bonds) in an effort to boost returns in lieu of investing in risky stocks following a decade of negative returns. We are convinced that bond funds investors will realize negative returns by year-end, and that the domestic stock market presents the greatest risk-reward opportunity. ■

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