



FULLER
ASSET MANAGEMENT, LLC

Charting a Course for the Future

7150 East Camelback Road · Suite 444, Scottsdale, AZ 85251
Tel: 480.477.8155 Fax: 480.477.8157
2 Wisconsin Circle · Suite 700, Chevy Chase, MD 20815
Tel: 240.235.5034 Fax: 240.235.5035
www.fullerassetmanagement.com

2007
Review &

JANUARY 2008
VOLUME 4 • NUMBER 1

2008 Market Outlook

LAWRENCE FULLER

Managing Director and Portfolio Manager

Investors will remember 2007 as the year of the sub-prime loan. The speculative investment vehicles conjured up by Wall Street firms to purchase these loans, combined with the deceptive AAA ratings awarded these investments by rating agencies, wreaked havoc throughout the stock and bond markets as the housing market began to crumble. The Federal Reserve responded to this financial crisis with three quarter-point cuts in short-term interest rates and a huge increase of liquidity into the financial system. Despite the turmoil, the Dow Jones Industrials finished 2007 with a gain of 8.8%, the Standard & Poor's 500 ended up 5.5%, and the Nasdaq Composite ended up 9.8% (total returns). Sector selection was critical to outperforming the market averages. The energy (+32.4%) and materials (+20.0%) sectors posted the best returns, while the consumer discretionary (-14.3%) and financial (-20.8%) sectors saw huge declines.

We forecast in our 2007 *Market Outlook* that the divergence between explosive growth in developing economies and slowing growth in the U.S., led by housing, would continue to lead to rising energy prices and market leadership for the energy, industrial and material sectors. We predicted that employment growth would slow, the dollar would decline, the core inflation rate would near 2%, and that the yield on the 10-year Treasury would decline towards 4%. We were slightly too optimistic in expecting the Fed to lower interest rates in the first half of 2007, but they did come through with three rate cuts in the second half of the year in response to the credit crisis. Our belief that alternative energy would become main stream is still up for debate, but we see this as a continuing trend. Our avoidance of

the consumer discretionary sector proved prescient as the rapid decline in housing and slowdown in consumer spending unfolded.

Our greatest miscalculation last year was in presuming the financial sector would outperform in response to lower short-term interest rates and an increase in money supply. While we did forecast the meltdown in the sub-prime lending market and the mortgage-backed securities that held these loans (review our March 1, 2007 *Outlook*) we did not anticipate the impact that sub-prime debt would have on the rest of the credit markets. We believe the ABX Index was the prime culprit in the sector's poor performance. This

Our forecast for 2008 is grounded in the belief that the U.S. economy will avert recession as the mid-cycle slowdown which began last year continues to develop.

index, compiled every six months to reflect the value of mortgage-backed securities, represents a mere \$28 billion in a market that exceeds \$1 trillion in value. The index is vulnerable to significant manipulation by speculators. Financial institutions were forced to value all the mortgage-related securities on their books in accordance with the ABX Index, leading to massive write-offs and reductions in capital which they use to lend. We

believe these losses are significantly overstated. We think financial institutions have written off more than is required in order to reduce their taxable revenue. When the value of these securities is realized, it will not be a taxable event, but, in our opinion, it will increase capital, book values, and share prices.

Our forecast for 2008 is grounded in the belief that the U.S. economy will avert recession as the mid-cycle slowdown which began last year continues to develop. We will hear much throughout the year about recession, because it will feel like one for the average

American, yet we believe the economy will continue to expand, albeit at a paltry rate of 1.0-1.5%. We see some narrowing in the growth divergence between developing and developed markets that may lead to a significant correction in developing stock markets, but we view this as a buying opportunity. The developed economies of Canada and the U.K. are now cutting interest rates as the U.S. does, just as developing economies have begun to increase rates. We may also see a significant correction in broad-based commodity indexes due to slower developing world growth, but this will also be temporary.

Oil prices should spike above \$100/barrel in early 2008 and remain in a range of \$80 to \$100 throughout the year, but we believe a more significant event for the energy markets will be a huge increase in natural gas prices. A significant decline in Canadian natural gas production, which represents about 15% of U.S. consumption, will crimp the available supply to the U.S. and drive prices up as much as 50% in 2008.

Despite recent concerns over headline inflation, we think deflation will resurface as a greater concern in 2008. We see declining home prices and wage growth as the drivers behind a deflationary trend. Restrained wage gains will limit the ability of companies to pass along higher food and energy costs, and the huge increase in global liquidity, which is increasing capacity and supply, as opposed to increasing demand, will limit the rise of core inflation.

We believe the dollar and long-term interest rates will bottom in 2008. A global economic slowdown and foreign central banks rate cuts will support the dollar, and weak employment growth in the U.S., combined with stable core inflation rates, will limit a significant rise in Treasury yields.

We don't see a bottom in the housing market in 2008. Home prices will continue to decline throughout this year, reaching a bottom sometime in 2009, at which point prices nationwide will have declined 20% or more from their 2006 peak.

The negative wealth effect from declining home prices will reduce the rate of growth in consumer spending to recessionary levels. Employment growth will slow well below 100,000 per month and the unemployment rate will rise above 5%. We believe the Federal Reserve will be forced to lower short-term interest rates at each of its next four meetings, resulting in a Fed Funds rate of 3-3.5%.

Despite all the headwinds for the consumer, the housing market, and the U.S. economy, we see potential for above average gains in the stock market. The Standard & Poor's 500 is extremely undervalued relative to bonds and real estate. Furthermore, historical data shows that when the Federal Reserve cut interest rates three or more times coinciding with economic growth of one percent or less, the stock market returns significant gains.

We remain fully invested in our investment portfolios and favor the energy, industrial, material and technology sectors as we enter 2008. The financial sector will recover its losses from 2007 as the Fed cuts rates, the yield curve normalizes, and the credit crisis eases. We continue to avoid the consumer discretionary sector and the healthcare sector. Healthcare has historically outperformed during periods of slowing economic growth, but we remain concerned about the negative investment implications of potential policy changes as a result of a Democratically led Congress and the probability that the Democrats win the White House in 2009. We continue to emphasize growth over value and large-to-mid-sized global companies over small companies. ■

Fuller Asset Management, LLC (FAM) is an SEC registered investment advisor. FAM and its representatives are in compliance with the current notice filing requirements imposed upon registered investment advisers by those states in which FAM maintains clients. FAM may only transact business in those states in which it is noticed filed, or qualifies for an exemption or exclusion from registration requirements.

This newsletter is limited to the dissemination of general information pertaining to its investment advisory/management services. Any subsequent, direct communication by FAM with a prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the prospective client resides.

For additional information about FAM, including fees and services, send for our disclosure statement as set forth on Form ADV from FAM using the contact information herein. Please read the disclosure statement carefully before you invest or send money.

©2007 Fuller Asset Management, LLC. All rights reserved.