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Charting a Course for the Future

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Market Outlook

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In 2008 our financial markets suffered their worst decline since the Great Depression. The Dow Jones Industrials finished the year with a loss of 33.8%, while the Standard & Poor's 500 declined 38.5% and the Nasdaq Composite fell a historic 40.5%. The general public and media-at-large have come to what may seem a logical conclusion. The collapse in home prices and the record increase in delinquencies and foreclosures brought an end to consumption-based growth, dragging the economy into recession at the beginning of the year and devastating our financial markets by year-end. From the perspective of Wall Street, this is a convenient line of thinking, because it conceals the real root cause of the financial crisis that propelled the economy into recession in September and simultaneously destroyed the markets in the process.

In retrospect, we think we cast a very pragmatic outlook for the economy and markets one year ago. We forecast that U.S. economic growth would slow to a paltry 1-1.5%. We stated that home prices would continue to decline throughout the year, the unemployment rate would rise above 5%, and the negative wealth effect would reduce the rate of growth in consumer spending to recessionary levels. While the dominant concern at that time was a 17-year high in the rate of inflation, we predicted that "deflation will resurface as a greater concern in 2008." Our optimistic outlook for stock prices was based on historical precedent. We believed that the gradual reduction in short-term interest rates by the Federal Reserve, coupled with slowing economic growth and a declining rate of inflation, would lead to an increase in stock valuations, as it had in the previous mid-cycle slowdowns of the 1980's and 1990's. Pragmatism proved to be costly and naïve in 2008.

We don't have any excuses for what was a horribly inaccurate outlook for the stock market last year. In our opinion, a confluence of events on Wall Street

that began with the bailout of Bear Stearns in March and ended with the bankruptcy of Lehman Brothers in September, together with the manner in which these events were mishandled by policy-makers and regulators, were the root cause of the crisis in financial markets and the resulting recession that immediately followed. Despite anticipating many of the events that unfolded in the real economy, identifying numerous regulatory potholes and systemic risks built into the system, we made the assumption that actions would be taken by policy-makers and regulators to prevent financial Armageddon. We were wrong -- at a tremendous cost.

The bailout of Bear Stearns by the Federal Reserve sent the misleading message that the central bank would

not allow the mismanagement of one firm, or the activities by those seeking to profit from its demise, to destroy the rest of the financial system. What followed can only be described as anarchy. Wall Street became imprisoned by the deregulation intended to promote the free market. Its jailers were speculators, who capitalized on limited oversight and regulatory deficiencies in order to profit from the systemic risk pervasive throughout the system, no matter what the cost.

Policy-makers and regulators turned a blind eye as the markets were taken hostage by a storm of self-destructive speculation that overwhelmed the fiscal and monetary stimulus intended to revive economic growth.

The magnitude of price manipulation in stocks, bonds and commodities was unprecedented. Investment tools and practices created to hedge and protect morphed into weapons of financial destruction. Speculators purchased credit default swaps and then employed the illegal practice of naked short selling to force runs on excessively leveraged investment and commercial banks that were already under strain from depressed asset bases, as a result of irrational mark-to-market accounting rules. Allowing investors to purchase insurance (credit

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default swaps) on debt they do not own is ridiculous. Allowing investors to sell this insurance without the requirement of maintaining any capital in the event of a claim is reckless beyond comprehension. These practices alone have destroyed far more capital than the losses incurred from home foreclosures, and they have cost the American taxpayer many times over the cost of bailing out the automakers in Detroit. Under the same free market ideology, removing barriers on commodity exchanges that enabled speculators to determine the prices of basic necessities, like food and energy, was a devastating blow to consumers and businesses over the summer months.

The government's lack of consistency in dealing with the numerous bankruptcies, bailouts and mergers further undermined market stability. But it was what now appears to be a momentary lapse of his customary ineptitude by Treasury Secretary Henry Paulson, in allowing Lehman Brothers to fail, that collapsed the house of cards on which our financial labyrinth had been built. The bankruptcy of Lehman Brothers led to the immediate closure of credit markets. Frozen credit markets brought global economic activity to a standstill and propelled an already fragile economy into a steep recession. A global deleveraging process ensued, decimating stock, bond and commodity prices. Yet this deleveraging process, as painful as it has been, purged much of the systemic risk. It also revealed the regulatory deficiencies that policy makers have now been forced to acknowledge and will be forced to address.

If investors fail to recognize that the current recession is the result of a credit freeze, and that the market decline is a function of forced deleveraging, they will fall victim to the irrational pessimism that prevails today. This is not to say that rising delinquencies and foreclosures, falling home prices, and unemployment are not serious headwinds as we enter 2009. Yet we believe the deleveraging process has run its course and that the worst of the recession is behind us. The rapid decline in economic activity over the past three months was a result of a contraction in credit rather than a decline in demand. Credit markets have begun to thaw and we

see the U.S. economy growing again this summer.

The economic and financial turmoil will require the massive stimulus plan to be proposed by the Obama administration in the days ahead. We believe this affords the opportunity to address serious issues our country faces that have long been neglected due to misguided priorities and short-term inconveniences. We expect significant policy changes in the areas of healthcare, energy and infrastructure. America needs work to be done and Americans need work. While those less optimistic about the U.S. economy claim the debt-laden American consumer is dead, we believe the engine of growth is shifting from consumption to construction. While America rebuilds its infrastructure, the consumer will rebuild his balance sheet by refinancing at historic low interest rates.

There are no bulls at bear market bottoms and the economic data will be horrific in the months ahead. It would be easy to reverse course at this stage and join the bearish consensus view, but we have been through the eye of the storm. The stock market has bottomed, on average, approximately six months prior to the end of every previous recession. We believe that the current recession will end by summer, and that the stock market low of November 20th will hold. The only bubble we can identify today is in the Treasury bond market. This bubble was born not out of greed, but rather out of fear, with investors willing to accept a nearly zero rate of return in an effort to seek safety. As a result, the outstanding liquidity in the financial system is staggering. The Federal Reserve has cut short-term interest rates to a historic low, and more importantly, has committed to do in the weeks ahead what Treasury Secretary Paulson failed to do in November with the \$700 billion Troubled Asset Relief Program – buy financial assets! We expect bond prices, with the exception of Treasuries, to rise dramatically in the months ahead. We expect stock prices to follow as the market looks beyond the economic downturn and towards the recovery. We continue to believe, as stated in November, that we may be embarking on one of the best five-year periods in history for U.S. stock performance. ■

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