



FULLER
ASSET MANAGEMENT, LLC

Charting a Course for the Future

7135 East Camelback Road · Suite 230, Scottsdale, AZ 85251
Tel: 480.553.6352 Fax: 480.553.6353
2 Wisconsin Circle · Suite 700, Chevy Chase, MD 20815
Tel: 240.235.5034 Fax: 240.235.5035
www.fullerassetmanagement.com

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2010 Market Outlook

LAWRENCE FULLER

Managing Director and Portfolio Manager

In 2009 our financial markets staged a historic rally from the bear market low established in March. That low coincided with what was the deepest point of contraction in economic activity during the worst economic downturn since the Great Depression. The Dow Jones Industrials finished the year with a gain of 18.8%, while the Standard & Poor's 500 rose 23.5% and the Nasdaq Composite soared 43.9%. Technology led sector performance for the year up an astonishing 59.9%, while the telecommunications sector was the worst performer, finishing the year up just 2.6% (source: Bloomberg.com).

We began last year with an outlook that stock and bond prices, with the exception of Treasuries, would rise dramatically, on the basis that the forced deleveraging and panic-selling that devastated asset prices had run their course, and that the recession most feared was a depression would end by summer. We challenged claims by Wall Street's most celebrated analysts that our banks were insolvent, undercapitalized and near nationalization just two weeks prior to the March lows. We established an upside target of 1200 for the S&P 500 at the end of April, believing that those sectors more leveraged to an improvement in the economic outlook, such as technology, industrials, financials and consumer discretionary, would lead in performance, while more defensively oriented sectors like healthcare, consumer staples and utilities would lag. We maintained our bullish stance throughout the year, focusing on the steady improvement in leading economic indica-

tors that began in April as our guide.

As we reflect on the accuracy of our predictions over the past year, it comes as a small consolation to our shortcomings in the fall of 2008, when we fell victim to the same confirmation bias that we believe afflicts the majority of individual investors today. Investors are rightfully disillusioned after a decade marked by two recessions, worn out from two wars and a deficit that have no end in sight and absent any growth in industrial production, employment or real wages. The

S&P 500 has lost an average of nearly 1% per annum for the past ten years – truly a lost decade. Furthermore, the investor class holds great disdain for the populist policies of the Obama administration, the bailouts on Wall Street, and the general ineffectiveness of elected officials that refuse to accept responsibility, instead directing blame towards anyone but themselves. In this environment, it is human nature to conclude

that the future will be bleak, and then search for evidence that supports this conclusion.

The media serves to further entrench the prevailing attitudes of investors by awarding experts with extreme ideological views on either side of each issue more exposure and attention than they deserve. Common sense and practicality usually fall somewhere in between, as both sides distort reality in an effort to support their arguments. The most popular and mainstream views about our current state of affairs are often best depicted on the covers of maga-

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zines. One of *Time's* recent issues was titled, "The Decade From Hell," and a recent cover of *The Economist* shows a map of the United States falling into a chasm with the likeness of the Grand Canyon.

These sentiments are a far better representation of what has been, rather than an indication of what is likely to be in the future. Unwavering pessimism was a prerequisite to a legitimate market outlook at the beginning of 2009 for the consensus of investors, similar to the way cautious skepticism is today, yet stock and bond prices soared over the past nine months in what was the greatest percentage increase on record. As dismal as the prospects were at the beginning of 2009, the outlook could not have been any brighter at the beginning of the decade just ended, with government surpluses, near full employment and unprecedented prosperity. Few anticipated that we had come to the end of an 18-year secular bull market that began in 1982.

The flow of funds in 2009 best exemplifies the bearish sentiment that prevails today. The cash hoard earning negligible returns still stands well north of \$3 trillion. Inflows of money into bond funds, gold, emerging markets and hedge vehicles stood in sharp contrast to the steady outflow of dollars from domestic stock funds throughout the year. We acknowledge that the state of the economy looks as grim today as it did following the severe recession of 1981-82. That was a time when deficits were soaring, unemployment exceeded 10%, and regressive tax cuts led to the elimination of interest deductions on every form of loan except home mortgages. The S&P 500 had produced a negligible real rate of return for nearly 16 years. Few foresaw the beginning of what would be an 18-year secular bull market in August 1982, during which the S&P 500 averaged double-digit rates of return.

It has been said that necessity is the mother of all

invention. It was the necessity to build up our national defense during the Cold War in the early 1980's, and the deficit spending that allowed us to do so, that gave birth in part to a technology revolution which transformed our economy and propelled economic growth in the years that followed. Today's greatest necessity is energy. We expect solutions to the skyrocketing demand for new sources of energy

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to be at the forefront of the next secular bull market. We believe this bull market began last March, as we find ourselves at a similar crossroad to that of August 1982.

The improvement over the past nine months in leading economic indicators and the rate of decline in unemployment claims mirrors that which took place in 1982. We believe the unemployment rate peaked at 10.2%, and that January data will show the

economy is creating jobs again. Regardless of the ideology behind fiscal and monetary stimulus, there is no denying a synchronized global upturn in economic activity is underway. Powering the recovery in the year ahead will be a staggering rise in industrial production to rebuild the record plunge in inventories, increases in capital spending by corporations and continued improvement in our trade deficit. We anticipate the spending of remaining stimulus funds on infrastructure projects will accelerate as we near the mid-term elections in November, serving to strengthen the robust data we would normally expect to see at this stage in the business cycle. We expect the economy will grow in excess of 4% and corporate profits will rise 25% in 2010. Based on these expectations, we are raising our target for the S&P 500 to 1350.

This outlook considers historical precedent, human nature and the current economic and investment landscape. Investors need to recalibrate their US-centric way of thinking to grasp the power of the recovery, for it is unlike any other in recent times. Waiting for a resurgence in home prices or consumer spending as an indication of economic health will leave investors

empty-handed. This recovery is being led by developing countries, historically debt-laden and dependent on the U.S. for growth following previous economic downturns. Today, these countries, led by China, India and Brazil, have trade and budget surpluses and an emerging middle class to lead global growth.

We are fully aware of the headwinds the market is likely to encounter as the year unfolds. Our housing market is in the early stages of stabilization, growth in consumer spending will be lackluster as the savings rate rises and many of the federal government's initiatives will detract from real growth. The fiscal and monetary stimulus programs will eventually wind down, and the economy will be forced to rely on the private sector for growth. The recovery will ultimately lead to higher rates of inflation and interest rates, as real growth strengthens and becomes more consistent.

Where we see risk in the financial markets is where most individual investors have sought a safe haven over the past year. Long-term interest rates are likely to rise from current levels, diminishing returns for bond fund investors. The dollar is likely to strengthen modestly, limiting the upside potential for gold investors. While we expect the core rate of inflation in the U.S. to remain tame in the year ahead, the nominal rate, which includes food and energy, should rise as the global economy recovers. We believe this will force central banks in developing countries to tighten monetary policy sooner than most expect, leading to what could be a significant correction in emerging markets. We expect the Federal Reserve to raise short-term

interest rates this summer. Although this event is highly anticipated, previous Fed tightening cycles have led to modest corrections in the stock market. This will likely dictate a rotation out of market sectors more leveraged toward economic expansion, and into more defensive ones. It may also present headwinds for commodities.

We continue to believe the stock market's advance will be led by the energy, materials, industrials and technology sectors as the recovery gains speed in the first half of the year. The financial sector presents one of the greatest risk-reward scenarios to us through out year-end on the basis of a return to normalized earnings. While our outlook is extremely bullish, we do not intend to turn a blind eye to the message that the markets may be sending through relative price movements in various asset classes. The lessons we learned in 2008 are forever burned into our psyche, and we refuse to entrench ourselves in an outlook based upon what we think should transpire. When the facts change, so will our outlook. ■

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