FULLER
ASSET MANAGEMENT, LLC
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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

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Market Outlook

LAWRENCE FULLER
Managing Director and Portfolio Manager

The stock market plunged in June with the Standard & Poor's 500 (-8.4%), the Dow Jones Industrials (-10.2%) and the Nasdaq Composite (-9.1%) all suffering significant losses. Energy led sector performance with a gain of 2.2%, while financials were the worst performing sector, posting a loss of 18.7%. We would prefer to discuss the outlook for corporate earnings and the economy, or the merits of traditional asset classes like stocks, bonds and cash, but at this point in time it is all about the emergence of a new asset class -- Oil!

> Market bottoms take time to form and usually occur when the outlook is at its worst, yet we still see reasons to be optimistic. The U.S. economy is not in recession, corporate earnings continue to grow outside the financial sector and the liquidity necessary for the stock market and economy to recover is available in the form of $4.5 trillion in cash yielding less than 3%.

When we fail to maintain or significantly weaken regulations designed to improve transparency, maintain market stability and prevent manipulative practices, we are more likely to see an allocation of investment capital that destroys more than it creates. This practice is known as malinvestment. Proponents of free markets are ardently opposed to regulation of any kind, but the ultimate price we pay for unregulated free markets may not be as "free" as we originally thought. We are still suffering from the ill effects of loose lending standards and the promotion of exotic mortgage products that led to the housing bubble.

The losses resulting from mortgage delinquencies and home foreclosures have been dwarfed by those incurred in the unregulated credit default swap (CDS) market. These derivative contracts were invented a decade ago with the intention of minimizing risk by allowing a bond holder the ability to insure his principal, should the credit of the issuer deteriorate, much the same way one purchases life insurance to insure his family against financial loss in the event of his death. A lack of regulatory oversight enabled speculators to purchase this insurance with the intent of betting against a company's ability to repay its debts, rather than insuring against loss.

Compounding the risk is the practice of selling these insurance contracts to multiple speculators, none of whom owned the underlying debt, and not requiring the underwriters to maintain any capital to meet potential claims. This arrangement gives the purchaser of a credit default swap a vested interest in damaging the reputation and credit rating of the company issuing debt, in an effort to increase the possibility of default, thus realizing a claim. The destructive misuse of these financial instruments has only served to further tighten credit markets, prolonging and deepening the economic downturn.

Now we face the repercussions of malinvestment of a different sort, as our largest investment institutions continue to transition from financial assets into hard assets. The deregulation of futures markets has opened the floodgates to an investment flow that our commodities markets are too small to absorb. This has resulted in an exaggeration of the current uptrend in oil that we contend could be as much as $40/barrel. These investors claim oil's record price increase year-to-date is based solely on supply and demand fundamentals, but we don't see lines at the gas pump, or an outcry from oil importing nations that they are unable to obtain the oil they need. To the contrary, today's high prices are destroying demand and the outlook continues to weaken as oil consumption in the U.S. is on pace to decline year-over-year. The rise in oil prices this year is due to speculation on concerns about future

oil supply and demand. When prices realign with today's reality, investors will look to take profits and sell with the same ferocity with which they bought futures contracts.

The stock market corrections in January and March can both be attributed to the escalation of the credit crisis, but the retest of these lows in June is a direct result of inflation fears due to rising oil prices. We see a reversal of the destructive trends in both credit and commodity markets in the second half of this year that will result in a substantial rotation out of those sectors that have been the greatest beneficiaries of global growth - energy, industrials and materials. We think the primary beneficiaries of this rotation will be the technology and financial sectors.

The incremental increase in demand for raw materials and energy over the past five years is a direct result of growth in developing countries. As prices for commodities soar, the central banks in these countries continue to raise interest rates to combat inflation, in turn slowing economic growth. We believe the fundamentals for the energy, materials and industrial sectors are gradually deteriorating as many companies become victims of their own success. A peak in the cycle is near when the price increases that material companies are obtaining no longer offset their own transportation costs, and energy stocks are no longer appreciating commensurate with the rise in the price of oil they sell. China joined India and other developing countries in cutting fuel subsidies last month, which effectively raised fuel prices 17%.

We believe that demand destruction will ultimately reverse the investment flow into oil, leading to a decline in price closer to $100/barrel. This will remove a major obstacle to higher stock prices outside of the energy, industrial and material sectors, as inflation fears dissipate, and consumer confidence and investor sentiment improve.

It may seem as ludicrous as proposing in 2006 that home prices would suffer their first annualized decline on record, but we see improvement in the sub-prime mortgage market and in the fundamentals for the banking industry. The dollar volume of newly delinquent sub-prime loans originated in 2006 and 2007 has been steadily declining this year, as has the rate at which delinquent loans move into foreclosure. This means credit quality is improving for the banking industry at the same time deposits are increasing, profit margins are rising and costs are going down. We believe the write-offs already accounted for by the financial industry will far exceed the loan losses ultimately realized. As credit quality improves, the accounting losses on the balance sheets of financial companies will become realized gains. We believe the sector presents one of the best long-term investment opportunities since the early 1990s.

While most people admire Warren Buffet's investment acumen, very few have the patience to share his investment time horizon, or his ability to look past the emotion that dictates short-term movements in the market. Market bottoms take time to form and usually occur when the outlook is at its worst, yet we still see reasons to be optimistic. The U.S. economy is not in recession, corporate earnings continue to grow outside the financial sector and the liquidity necessary for the stock market and economy to recover is available in the form of $4.5 trillion in cash yielding less than 3%. The Federal Reserve was the first central bank to begin raising rates in 2004 and the U.S. economy was the first to slow. Since the Federal Reserve was the first central bank to lower rates, we expect the U.S. economy to be the first to recover. We have reduced our exposure to the energy, industrial and material sectors and increased our exposure to technology with a focus on alternative energy. We believe the recent spike in oil will lead to a global boom in alternative energy-related spending with the prime beneficiaries being wind and solar. It should be a wakeup call that leading oil producing nations in the Middle East are investing more capital in renewable energy than we are in the United States. ■

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