



# Market Outlook

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The stock market spent most of June treading water as it worked to solidify three months of consecutive gains. The Dow Jones Industrials and Standard & Poor's 500 were virtually unchanged, while the Nasdaq Composite managed to climb 3.4%. The market took a more defensive tone, with utilities leading sector performance, posting a gain of 5.1%. The materials sector was the worst performer, posting a loss of 4.9% (source: Bloomberg.com).

Despite the market having rallied 40% from the lows established in March, it remains 40% from its highs reached in October 2007. We have probably come to an inflection point where market prices have completely retreated from the fear of Armageddon and returned to a state of normalcy. The easy money has been made, or in most cases, recovered. Further gains will require a marked improvement in economic indicators as opposed to a stabilization of the rate of decline.

Investors have been skeptical of the market's torrential advance since the day it began. Many leading economists and market strategists have been equally skeptical of an economic rebound on which future market gains will depend. We believe that much of this skepticism is rooted in a philosophical disagreement with the means by which the government is trying to achieve the end we all desire – an economic recovery. The Keynesian policies the Obama administration has implemented to revive the economy have been widely criticized, and understandably so, because of the deficits they produce along the way. Yet allowing a philosophical rift

with these means to bias one's interpretation of new developments, and maintaining a negative outlook for the economy and markets as a result is self-defeating. A bearish outlook at this stage in the economic cycle simply contradicts logic.

Skeptics point to the fact that we lost 345,000 jobs in May and that the unemployment rate jumped to 9.4%. We would focus on the fact that this is half the number of monthly job losses we had six months ago, and the smallest drop since the credit crisis began last September.

Layoff announcements and initial unemployment claims have been steadily declining, and continuing claims saw their first weekly drop since January. While the absolute numbers are ominous, it is the rate of change in the number and the direction it is moving that matters to investors. Today's numbers indicate to us that we could see job growth before year-end.

Skeptics are quick to remind us that existing home prices are down 18% year-over-year and nearly 27% from their peak, according to the Case-Shiller house price index. New home starts continue

to decline and the number of existing homes for sale remains elevated. From our vantage point, existing home prices saw the smallest month-over-month decline (-.8%) in nearly a year, and the fall from the peak has brought home prices back in line with their historical relationship to incomes. The number of homes for sale is now falling, because existing home sales are on the rise at a rate above new listings (including foreclosures). We believe home prices will begin to rise again before year-end.

We believe that the unprecedented amount of fiscal and monetary stimulus, combined with the record number of policy actions on a global basis, collectively support an S&P 500 valuation of 1200, which implies a 30% rise from current levels.

Skeptics focus on the record plunge in industrial production reminiscent of the 1970s, and on the fact that inventories are on track to decline more in the second quarter than they did in the first. On the flip side of the coin, these inventories must eventually be rebuilt, and while they continue to decline, the Purchasing Managers Index (PMI) for new orders has started to increase. This presages a reversal in the inventory cycle and a significant rebound in production. A case in point is the auto industry, which skeptic or not, most would call a disaster. Chrysler and General Motors have shut down numerous assembly plants, fired thousands of workers, and filed for bankruptcy. Both companies will remain on government life support for a long time. Yet the silver lining most skeptics fail to acknowledge is that auto inventories have fallen so far below an already depressed rate of sales in recent months that auto production is scheduled to surge more than 50% in the third quarter simply to meet current demand. This demand will increase in the fourth quarter as tax incentives kick in from the cash-for-clunkers bill that Congress recently passed.

**T**he stock market historically bottoms coincident with a point in time during which the fundamentals couldn't look any worse (think bank nationalization), and it now appears that early March was that climactic low. Recessions have historically ended approximately three to six months following the market bottom. Based on this timetable and the improvement in leading economic indicators, we are convinced the recession is now over. The economy probably contracted 1-2% in the quarter just ended, and will likely grow 1-2% in the quarter just begun. The recovery is underway. Only \$53 billion in stimulus dollars have been paid out so far from the \$787 billion fiscal stimulus package, and regardless of whether we think it is needed or not, the pace will run approximately \$40 billion per quarter through the end of 2010. After all, it will be an election year. We believe real economic growth

next year will be more than double the consensus expectation of 1.7%.

As incoming data measuring the health of the economy gradually improves, we expect to see the classic revisionist response from leading economists and influential market strategists, redirecting the herd back into the markets and remolding the investor psyche towards an optimistic outlook. A glass now viewed by most as half empty, will eventually be seen as half full. Skepticism is critical to the longevity of every bull market, as it serves as a source of fresh demand for stocks as prices rise higher. There is no better real time measurement of this skepticism than the amount of cash sitting on the sidelines in money market funds yielding less than 1%. Despite the 40% increase in the S&P 500 since March, money market funds still total more than 50% of the value of this benchmark index, which is more than twice the peak levels reached during the market lows of 2002 and 1990. Money market funds have averaged approximately 20% of the value of the S&P 500 over the past 20 years. When this cash hoard eventually declines to normal levels, and negative sentiment capitulates to the bullish side of the aisle, it will be time to temper our optimism.

We believe that the unprecedented amount of fiscal and monetary stimulus, combined with the record number of policy actions on a global basis, collectively support an S&P 500 valuation of 1200, which implies a 30% rise from current levels. Healthy corrections of 5-10% along the way should be welcomed, as they will provide the cement necessary to sustain the advance. The sectors that should drive this advance will be those most levered to economic growth. We expect the technology, consumer discretionary and financial sectors to maintain their leadership positions into the third quarter, followed by the industrials, energy and material sectors. We expect more defensive sectors such as healthcare, staples, utilities and telecommunications to lag the market through year-end. ■

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