



Market Outlook

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Stocks soared for a third straight month in May as the green shoots that have taken root begin to blossom. We see a bright light at the end of the tunnel most believed was leading to another Great Depression just several weeks ago. The Dow Jones Industrials (+4.1), Standard & Poor's 500 (+5.3%) and Nasdaq Composite (+3.3%) all finished higher, led once again by the financial sector, which posted a gain of 13.1% (source:Bloomberg.com).

The herd mentality to sell financial assets from November of last year through February of this year was overwhelming. Bearish pundits held center stage, drowning out the voice of rational thought. Our sorry excuse for mainstream media, pouncing on the sensational rather than focusing on the sensible, did its best to make dire straits look apocalyptic. Lawmakers displayed oft-used and long-mastered skills of finger pointing and blame dodging. All the while, prudent investors like Warren Buffet were buying the very same assets the herd was looking to sell. Yet even after a 35% rally in the stock market from the March lows, there are more pundits that dismiss this recent rise as a sucker's rally than embrace it as a new bull market. The only reason investors might dismiss a soaring stock market is that they are not participating in it, which begs the question, who is the sucker?

Despite the unpopularity of the outlook, and the risk of being trampled by the herd back in March, we opined that, "If investors keep looking in the rear view mirror for direction, they will be run over by an oncoming train in the form of \$4-5 trillion of cash earning less than 1%. Investments viewed as safe havens today could be disasters in the not too distant future, as Treasury yields rise and asset prices inflate." To question the current rally indicates

a misunderstanding of the basis for the decline that began in earnest last September, as well as the mechanics of the market that drive asset prices higher. Stock prices declined rapidly after the bankruptcy of Lehman Brother due to the forced selling that ensued when credit availability collapsed. Fear accelerated and deepened the decline. As credit markets began to thaw and confidence in the financial system was gradually restored, the flight to safety reversed course. Money is the gas that fuels the engine of economic growth and inflates asset prices. The Federal Reserve opened the floodgates to the supply of money in response to the credit crisis, and most foreign central banks followed its lead. If money equates to gas in the tank, then interest rates are the accelerator, and central banks have the pedal to the metal, with rates now below 1% in many countries around the world.

We are now in the early stages of a global upturn in economic activity that is nearly as powerful as the decline instigated by collapsing credit markets last fall. From our perspective, all that is still up for debate is the speed and slope of the recovery. Consumer confidence, a leading indicator of consumer spending, is at an eight-month high. Both existing and new home sales appear to have bottomed, and the relationship between home prices and median income has returned to its historical average. Auto and retail sales are gradually improving, albeit from historically low levels, and trucking activity is picking up, indicating that businesses have begun to rebuild inventories.

As the fear and forced selling of recent months abate, investors will be looking for a rebound in corporate profits to push stock prices higher. The fact that consensus expectations are extremely low is a positive. We believe that profits will surprise to the upside as the economy begins to

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grow again, but for reasons not commonly discussed. When the economy contracts and corporate revenue declines, businesses lay off workers in order to reduce labor costs and protect profit margins, but they usually do so with a lag. This ultimately leads to a decline in profits that far exceeds the fall-off in revenues. When revenues do improve during an economic recovery, companies are equally as slow to rehire, which is the main reason that employment gains are a lagging indicator. As a result, the acceleration in profits can far exceed the growth in revenues. This dynamic is more likely to occur in the financial sector than any other.

Stress test results for the nation's 19 largest financial institutions were released last month, revealing that regulators are as asleep at the wheel today as they were when the credit crisis unfolded. The loan loss assumptions used to conclude that banks needed to raise billions in additional capital were completely absurd, yet most banks met the necessary requirements by month's end, and are now applying to repay the loans they received last fall. Meanwhile, the traditional banking business has never been more profitable, and reductions in head count to reduce expenses have nearly run their course. We believe earnings could potentially soar as the year progresses.

An unanticipated source of these future profits is likely to be a reversal of losses banks were forced to take in the past that never materialized. The toxic assets that the Troubled Asset Relief Program (TARP) originally intended to purchase last October remain on bank balance sheets. As their market value declined, these unrealized losses reduced bank profits and the capital on which banks lend. The Treasury is now in the process of launching a new government program, called the Public-Private Investment Program (PPIP), to enable investment firms to purchase these assets. Good luck! These toxic assets, which total nearly \$2 trillion in face value, are predominantly residential mortgage-backed securities, and many are now rising in value from the depressed prices that banks were forced to mark them to at the end of March.

The banks no longer have the need to sell, but instead have an incentive to hold on. As market values for toxic assets continue to realign with the actual losses on loans held in the securities, banks will reverse prior losses and book gains moving forward. Perhaps this is why Bank of America is attempting to nullify the government guarantee on more than \$100 billion in securities they acquired in the purchase of Merrill Lynch.

There are always issues to be concerned about on the investment landscape. The deficit spending necessary to restore economic growth and battle the deflationary spiral has led to a decline in the value of the dollar, and in turn a rise in oil prices. We believe we are witnessing a repeat of last summer, when institutions used commodities as an asset class to drive crude oil to an all-time high of \$150/barrel. The volume of unregulated trading in commodity derivatives is surging, and commodity prices across the board are on the rise, despite supply-and-demand fundamentals that are not supportive of such a substantial move. This has led to a rise in gas prices that will likely continue, pinching disposable income for consumers. Other notable areas of concern are the additional job losses that will result from the downsizing of the auto industry this summer and the recent rise in long-term Treasury yields that has pushed mortgage rates back above 5%. At this stage we do not think these issues will derail the recovery.

It has long been said that investors should "sell in May and go away," because the summer months usually lead to dismal market returns. The fallacy in this line of thinking is that the market has performed well above average during periods when leading economic indicators are improving, as they are today. This year is reminding us more and more of 2003, a period during which the Federal Reserve had lowered rates to 1% and dramatically increased money supply, and the market continued to throttle upward. Our upside target for the S&P 500 remains 1200 for 2009. So long as the pundits and the investors that follow their lead continue to question the advance, we are confident it still has further to go. ■

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