



Market Outlook

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May was a horrible month for the stock market. Fears intensified over the sovereign debt crisis in Europe as concerns shifted from default risk to the impact austerity measures would have on economic growth. Pundits hypothesized that lower rates of economic growth in Europe, combined with efforts underway in developing countries to slow their own economies, could undermine what most see as a fragile U.S. recovery. Financial regulatory reform arose as another headline risk when the Senate debated several amendments to the proposed legislation that investors feared could hurt profits at financial companies. The Dow Jones Industrials (-7.9%), Standard & Poor's 500 (-8.2%) and Nasdaq Composite (-8.3%) all finished the month with significant losses. Telecommunications led sector performance with a loss of 3.9%, while the energy sector was the worst performer, posting a loss of 11.8% (source:Bloomberg.com).

We view the recent selloff as nothing more than a correction, defined as a decline of 10-19%, which is customary at this stage of a bull market. We have seen corrections that averaged 15% in each of the previous 12 bull markets dating back to the Great Depression—they are par for the course. Last month we discussed our rationale for having reduced domestic stock exposure in anticipation of such a correction. Investors were simply too complacent with respect to the

sovereign debt crisis unfolding in Europe, given the feeble and disjointed policy responses from the EU and ECB up to that point in time. We stated that when “heightened levels of risk are brought to the forefront of investors’ minds, they will be factored into market prices very quickly, and lead to what we believe will be yet another opportunity to invest in domestic equities.” To say that market prices declined “very quickly” would be an understatement. The S&P 500

fell nearly 15% from its April high to its intra-day low on May 25, pushing well below the 1100 level that we believed stood as support. We were not deterred by this decline, as it was expected, and we used it to increase our exposure to domestic equities.

Whereas investors were completely indifferent to the risks posed by sovereign debt a few weeks ago, now they are overwhelmed by systemic risks we simply don't see. The potential for a debt default has been taken off the table with the near \$1 trillion loan package orchestrated by the EU and IMF. Economic growth will undoubtedly slow when the required budget cuts for EU member

nations that receive loans under the new program are enacted. We expect the euro will continue to decline in value, and it would not surprise us if Europe slips back into recession later this year. Economic growth has yet to be addressed. We believe the ECB will reactively lower short-term interest rates and implement quantitative easing measures similar to those employed by the Federal Reserve over

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the past year. They will purchase sovereign debt, so as to support the balance sheets of the banks holding this debt, and give up efforts to sterilize any increase in the money supply. This will be the monetary response to what we see as a deflationary environment, but the EU will ultimately have to grow its way out of this fiscal crisis with economic stimulus coming from the stronger member nations, much the way the United States is attempting to do so now.

The silver lining in Europe's deteriorating growth outlook is that efforts by China and other developing countries to slow their own economies may come to an end. Inflation no longer poses as serious a threat as waning export growth to Europe. We believe China is on the cusp of ending efforts to reign in growth, and that such steps, should they occur, will bolster our own export growth. More than half our exports now go to the developing world. From our perspective, Europe alone is not a significant headwind for the U.S. economy. Our financial institutions have negligible exposure to sovereign debt, and the percentage of annual revenues for U.S. companies in the S&P 500 coming from Europe account for less than 10% of the total.

Despite Europe's fiscal crisis, the U.S. economy continues to gain traction as the rate of change in nearly every data point we monitor is moving in a positive direction. Delinquency rates on consumer loans are falling and bank lending standards for consumers have started to ease. Consumer spending has risen at a 4.7% annual rate over the past six months and it has now exceeded its prior peak in 2008 on a nominal basis. Hotel occupancy rates are rising along with airline demand, trucking activity and shipping cargo volumes. Spending on advertising by small business has been steadily improving, rents are on the rise, and state income tax receipts are increasing. These facts tell us that employment growth, which is the foundation to a sustained recovery and the key to a continuation of this

bull market, is much stronger than private-sector payroll numbers suggest.

Payroll employment has increased four months in a row, and averaged nearly 200,000 jobs over the past two months, but the unemployment rate has remained stubbornly high. The reason for this is a staggering surge in the labor force since the beginning of the year. Yet we believe the household employment figures, which include the self-employed and small businesses, are painting a far more realistic picture. Household employment soared 550,000 last month and has increased nearly two million over the past four months. These numbers clearly justify

the improvement we are seeing in credit, consumption and economic activity, and they indicate that payroll employment figures are likely to continue increasing well into 2011.

We are far less exuberant over the prospects for meaningful financial regulatory reform. It appears as though lawmakers have once again sold their souls to Wall Street in exchange for either campaign cash or a cushy job as a lobbyist

or consultant should their prospects for reelection not look favorable come November. We will refrain from further judgment until the sausage-making process is complete, but any reform that does not enforce the ban on naked short-selling and regulate the credit-default-swap market is no reform at all. We are confident at this stage that the final product will have little to no impact on the profitability of the banking sector.

We think it is important to address the dramatic increase in market volatility that has unnerved investors in recent weeks. The data points we focus on are far too mundane to even be mentioned on the nightly news, and our commentary is typically devoid of the emotion and sizzle that routinely accompanies the headlines disseminated each day. We are not politically-charged pundits, television personalities or the cheerleaders most rely on for an interpretation of

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the news through mainstream media outlets. As investors, we concentrate on long-term trends rather than announcements, events or news bites, but there is a relatively new and fast growing sub-species of supposed asset managers that focus on nothing but the daily diatribe. They are known as high frequency traders. They accounted for nearly two-thirds of all the trades placed on the exchanges last year in what has rapidly become the most popular high-octane sport on Wall Street.

Last Tuesday, markets plunged on a rumor that China was considering reducing its holdings of European sovereign debt. Markets reversed course violently on Thursday when Chinese officials denied such rumors. Markets nosedived yet again on Friday following a downgrade of Spain's credit rating. This is nuts! First of all, who cares about Spain's AAA credit rating? We don't! Ask one of the sleuths on CNBC how a change in Spain's credit rating impacts the U.S. economy and you will see a blank stare. They have no clue, but they tell you it must be bad, because market prices have plunged on the news. This high-school drama is not where investors should be focused.

High frequency traders are nothing more than computer programs based on algorithms. Firms like Goldman Sachs spend millions of dollars developing and constantly tweaking these programs. Some are designed to interpret the headlines and sound bites as either bullish or bearish, and

then buy or sell baskets of securities based on these interpretations. Others are programmed to buy and sell based on technical price levels. The advantage high-frequency trading programs claim to have is that they make decisions faster than humans, but they also receive pricing information from the exchanges faster than we do, because their

servers are located on the site of the exchange itself. In our opinion, this is blatant front-running. This latest absurdity is the only rational explanation for the intra-day swoons in market prices we have seen recently, all in an effort to scrape a few pennies per millisecond in front of the order flow sent by commoners like us. The 1000 point drop in the Dow Jones Industrial Average on May 6 was no aberration. We expect there will be more volatility to come in both directions until regulators and lawmakers

wrap their hands around this latest waste of intellectual capital.

It takes a strong stomach and an unbreakable will to focus on the fundamentals in this new era of instant communication and the 24/7 news cycle. As unnerving as this increase in volatility may be, it is the mundane statistics we follow, and not the latest sound bite or headline the world chooses to focus on, that determine trend. The trend is far more important than the trade, and from our perspective the trend is still up for the U.S. stock market. ■

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