



Market Outlook

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The stock market is digesting a worst case scenario for the economy that could see unemployment rise to 10%, home prices fall an additional 15-20% and the recession last through year-end.

February, a terrible month for stocks, ends the worst six-month period for the market since 1932. The Dow Jones Industrial (11.7%), Standard & Poor's 500 (11.0%) and Nasdaq Composite (6.7%) all finished the month with losses (source: Google finance). No one knows if the recent retest of the November bear market lows will hold or press lower. We do know that markets bottom on very bad news, and that they eventually turn up on news that is still bad, but less so than expected. The point at which dismal expectations fall below the grim reality we face will mark the turning point.

President Obama is embarking on an ideological shift to Keynesian policies at record speed in an effort to end this recession and restructure the American economy. The American Recovery and Reinvestment Act contains \$789 billion of tax cuts, spending initiatives and investments in healthcare, education, energy and infrastructure. This stimulus plan hopes to create or save millions of jobs, boost economic growth in the second half of this year and address the structural deficiencies in our economy that will save money over the long term. The theory is that government spending will encourage consumers and businesses not to defer purchases and investments based on fears about the economic outlook. There is no doubt that no stimulus at all would lead to a deflationary spiral that would further

retrench spending and investment. The stimulus should add 2-3% to economic growth in the second half of this year and end the recession, but the debt burden will soar.

The Obama Administration's Homeowner Affordability and Stability Plan will use \$75 billion from the \$700 billion Troubled Assets Relief Program (TARP) to modify conform-

ing mortgages for families that are current on their payments, but at risk of foreclosure in the future. The plan targets 3-4 million homeowners in hopes of reducing the foreclosures that are driving down home prices, and it offers cash incentives to lenders and borrowers to encourage participation. Aside from the moral hazard issue of helping some and not others, this program could reduce foreclosures by as many as one million.

The Financial Stability Plan introduced by Treasury Secretary Timothy Geithner fell way short of expectations due to its

lack of specifics and his lack of charisma. The plan proposes a "stress test" for our largest banks to determine if they will be well capitalized should the economy worsen, but the results won't be revealed until April and no one knows what measuring sticks will be used. The plan also proposes new programs to allow private investors to borrow from the Treasury and the Fed at low interest rates, allowing private capital to purchase assets. The problem here is that they will only allow private investors to purchase the highest quality debt, not the toxic assets for which there is no market. They still don't get it! They must address the downward spiral in toxic asset market

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values in order to halt the negative feedback loop that is strangling credit availability.

Lawmakers and the media have vilified the banks and demonized the toxic assets that burden their balance sheets, thereby inflaming public outrage – The banks won't lend! While the banks are culpable, they hardly deserve all the blame. The system is to blame, and we are all a part of the system. The toxic assets are taxpayer liabilities in the form of home loans, car loans, real estate loans and credit card loans. Who is to blame for their toxicity? We blame irresponsible borrowers, loan originators, investment banks (that no longer exist) and banks that bundled the loans into investment securities, rating agencies that glorified the credit ratings for profit and our lawmakers that defanged and under-funded the regulatory bodies established to prevent this from occurring. There are also innocent borrowers with wages that have not kept pace with the rising cost of healthcare, energy and education expenses. The banks are a part of the problem, but they are now our only solution.

So why are banks not lending despite all the taxpayer funds they have received? The belief that loaning money from the TARP would help them lend was flawed from the start. Nearly 50% of our credit came from the securitization market, which shut down following the bankruptcy of Lehman Brothers. Banks would originate loans, bundle them into investment securities and sell them to replenish their capital in order to make new loans. Now there is no market for these loans because investors can't borrow and in some cases must liquidate what they previously purchased. This is constantly driving down the value of the existing loans that banks hold for investment and relentlessly eroding the capital they use for new loans. The Treasury has simply been filling the void with taxpayer funds all the way down. Yet lawmakers demand the banks lend, while regulators tell them that if they do, they will require more capital. It would be helpful if the public were better informed.

The mark-to-market accounting rule instituted in November 2007, just before real estate prices started to collapse, is the most significant contributor to capital

destruction, yet the government refuses to address the issue for fear it may be viewed as favoring the financial institutions that they blame for the crisis – politics! Do we force a homeowner that is current on his mortgage to increase his down payment if the value of the home falls below the mortgage? It is equally as absurd to force banks to take losses on loans that are performing, just because there is no rational price for that loan in the marketplace. End mark-to-market accounting!

The Fed and Treasury continue to jawbone the markets with talk of programs designed to purchase all assets, other than the ones that are troubling the economy (toxic assets), in a dire attempt to protect taxpayers dollars. If they refuse to revoke the absurd mark-to-market accounting rules that are hemorrhaging bank balance sheets, then the government must purchase the troubled debt securities that are destroying credit markets and hold them to maturity. Those experienced in these markets tell us that current prices now imply unrealistic default rates that exceed those of the Great Depression. They are undervalued! It is one or the other, and the longer they wait, the more damage that will be done to the markets and the economy, and the longer it will take for recovery. The Treasury and Federal Reserve proclaimed that they would buy troubled assets in October 2007. Since then they have attempted everything but that in an effort to appease misguided lawmakers and an uninformed and infuriated public. The Obama Administration must have the political will to break this negative feedback loop or the impact of economic stimulus will be muted.

Should our banks be nationalized? The king and queen of doom and gloom, economist Nouriel Roubini and analyst Meredith Whitney, have gained fame (and likely fortune) over the past year exclaiming that our largest banks are undercapitalized and insolvent, the shares are worthless and the government should nationalize them. This has obviously fueled tremendous fear and driven stock prices into the ground. The statistics don't support their claims. A bank's health is measured by weighing its assets or capital relative to its liabilities. This ratio (called Tier 1) is con-

sidered healthy when it exceeds 6%, and it accounts for the quality of the assets and liabilities a bank holds. The four largest banks all had Tier 1 ratios at year end of approximately 8-12%.

It is also difficult to claim insolvency when the revenue these banks earn, net their expenses and realized losses on loans, results in positive cash flow. The net losses they incur are a result of unrealized, mark-to-market accounting charges and accounting provisions for losses that have yet to occur. It is cash flows and asset values that determine the value of a bank. In the most recent quarter ended, a quarter that saw the greatest contraction in economic growth (6.2%) since 1982, Citigroup announced losses of more than \$12 billion. The "loss" resulted from nearly \$8 billion in mark-to-market losses on investments they hold and \$6 billion on provisions made for potential loan losses in the future. (source: Citigroup press release Q4 2008). These are accounting losses and have no impact on cash flows. The major disappointment with Citigroup management is that they succumbed to the pressure of the skeptics who demanded a far more draconian measure of assets relative to liabilities. This more stringent ratio involved converting the government's \$25 billion of preferred shares to common shares and amounts to nothing more than an accounting change. Now taxpayers own common stock in lieu of preferred stock that was paying an 8% dividend. This move may silence critics in regard to the bank's capital levels, but it drastically diluted common shareholders, and it places taxpayers in a position to profit purely from capital gains.

We believe our banks are solvent, well-capitalized and will not be nationalized. The decline in share prices down to levels not seen since the early 1990's may give pause to this claim, but banks were not subjected to

mark-to-market accounting at that time. We believe the irrational market prices on debt securities will reverse their decline when toxic assets are inevitably purchased. This should reverse the mark-to-market losses on these assets and dramatically improve bank balance sheets as we move forward.

The recession is global and the plunge in consumer net worth is unprecedented as all asset prices decline. Inflation is negligible as demand continues to weaken. We still believe home prices will bottom this year. Governments around the world have implemented massive stimulus and central banks continue to lower interest rates. At some point, these actions will inflate asset prices. A rise in asset prices will reverse the negative wealth effect and demand for goods and services will recover.

What is the point of owning common stocks at Depression-era valuations in the face of one of the worst recessions we have had since World War II? If this recession turns into a depression, then selling stocks at today's levels may be a good idea, and the most sensible alternatives would be cash or Treasuries. Despite the stock market (S&P 500) recording its worst year in 2008 since 1931, we do not see another Great Depression, and there are no other comparable statistics. The two longest recessions since World War II both lasted 16 months. We have now officially been in recession for 14 months. Should this recession end this year, regardless of how swift the recovery, we believe that common stocks will outperform other asset classes over the next 3-5 years, regardless of whether the recent November low holds or not. We are focused on owning companies over this period that will benefit from the inevitable recovery of the credit markets and the deficit spending by the federal government designed to transform our economy in the years ahead. ■

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