



Market Outlook

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The stock market ascent that began in March 2009 stalled on January 19th, at which point the S&P 500 had risen approximately 72% from the bear market lows. We view the correction that followed through early February as a healthy consolidation of these substantial gains. Despite this correction, the Dow Jones Industrials (+2.6%), Standard & Poor's 500 (+2.8%) and Nasdaq Composite (+4.2%) all finished the month on a positive note. Industrials led sector performance with a gain of 4.5%, while the utility sector was the worst performer, posting a loss of 1.8%. We believe it is now critical to differentiate between the varying stages and underlying strength of the economic recoveries underway in the United States, Europe and the developing world, led by China.

We continue to see a strong and steady economic recovery in the United States, yet the public has dismissed the idea, and the stock market for that matter, because they don't see it! Main Street's pain has been in many ways Wall Street's gain, but not in terms of bonuses and bailouts. Increases in employment and compensation have been muted since the recovery began, which in turn has been good news for inflation, productivity and corporate profits. The ratio of

corporate savings relative to investment is at a record high, while capital expenditure as a percentage of GDP is at its lowest level in 38 years. This is a business-led recovery, not consumer-led as it was in the previous recovery, driven by increases in capital spending and inventory rebuilding. The gains in productivity and profits we have seen to date are what will eventually lead to an increase in employment and then consumer spending. Were it not for severe winter storms that swept the country last month, we believe we would be realizing these increases by now. We anticipate the first significant rise in employment (100-200,000) when March figures are reported in early April. This may be the positive sign that shifts public and investor sentiment, setting the stage for the stock market to eclipse the highs we saw in January.

Beyond 2010 the country faces major headwinds. It was Albert Einstein who said, "We can't solve problems by using the same kind of thinking we used when we created them." The vast amount of funds set aside in the Recovery Act (\$275 billion) to invest in projects that create jobs has yet to be paid out. We have no explanation as to why, other than the obvious politicization of the funds in front of an election. The eventual spending will surely help sustain

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the recovery through year-end and into early 2011. Yet the majority of stimulus funds paid out so far have been used to postpone the harsh reality facing state and local governments in the years ahead – spending cuts and tax increases. The band-aids (stimulus funds) used to balance state budgets will fall off at the end of the year, and an additional \$53 billion will be needed to balance budgets in fiscal 2011. This doesn't begin to address the \$1 trillion gap between the assets state governments hold and their future health-care and pension liabilities. We remain cognizant of these longer-term issues, but do not think they present significant risks to the bull market this year. The impact long-term fiscal issues will have on financial markets in 2011 will be a function of the strength and sustainability of the expansion underway.

Our immediate concern now lies with international markets, and it has led to a change in our investment strategy. We stated at the beginning of the year that inflation abroad “will force central banks in developing countries to tighten monetary policy sooner than most expect, leading to what could be a significant correction in emerging markets.” Shortly thereafter, China increased short-term borrowing rates and regulator reserve requirements for its banking system in an effort to slow lending and avert price inflation. India has tightened monetary policy in hopes of containing a double-digit rise in food price inflation. We have also seen central bank rate increases in Australia, Malaysia and Israel. The benchmark for international stock market performance

We continue to believe the U.S. will be the best performing stock market in 2010. We established a target of 1200 for the S&P 500 in May 2009. We then increased that target to 1350 at the beginning of this year on the basis that the economy would grow in excess of 4% and corporate profits would soar 25% in 2010.

(MSCI EAFE Index) declined nearly 14% from its January 19th high before recovering some in recent weeks. What is troubling us is the recent divergence in performance between the international equity markets, led by China, and the United States. Despite what we expect to be robust growth in the developing world, we think the likely continuation of tighter monetary policy will limit the upside for emerging markets until later this year. But it is the European continent that concerns us most.

Europe's economic stimulus plan, and the recovery that followed, have been faint when compared to the U.S. and China, and we expect virtually no economic growth in 2010 as a result. More importantly, the manner in which the European Union deals with the fiscal crisis in Greece has broad implications for the rest of Europe. We believe the EU will bail out Greece, but any ad hoc intervention that does not also address the fiscal crisis facing the member nations of Spain, Portugal, Italy and

Ireland will be reminiscent of the Federal Reserve sweeping Bear Stearns under the rug of JP Morgan in March 2008. Could Greece be to Europe what Bear Stearns was to our financial markets in March 2008 – a warning sign? We don't know. What we do know is that the same vulture investors that manipulated the debt and equity prices of our financial institutions in 2008 have taken aim at sovereign debt in Europe. Their weapon of choice is the credit default swap. If the EU chooses to address the fiscal crises of member nations on a case-by-case basis, rather than contain the systemic risk through a program similar to that of the Troubled Asset Relief Program (TARP) in the

United States, then we fear more volatility in the months ahead. The indicators we rely on tell us to focus on wealth preservation with respect to international markets, and we believe it prudent to reduce that exposure at this time.

These concerns do not mute our optimism for domestic stocks. Despite efforts to contain inflation and slow its economy, we believe China will continue to lead the global expansion. The lending quotas established by the central government for 2010, while significantly reduced from 2009 levels, are still 40% above the trend that existed prior to the financial crisis in 2008. China's imports are now growing at a faster rate than its exports. Our exports to developing markets, which have surged at an annualized rate of more than 40% over the past six months, now exceed those to developed ones. There is a major shift in the balance of trade underway that we believe will offset the likely decline in domestic consumption resulting from higher taxes and reduced levels of public spending.

We are also finding reasons for optimism within our own borders. Home prices, as measured by the Case-Shiller home price index, have now increased seven months in a row, which strengthens bank balance sheets and increases consumer net worth. Even more encouraging was a decline in the 30-day mortgage

delinquency rate during the fourth quarter of last year. Some might discount this improvement as temporary due to government assistance, but the programs available do not prevent delinquencies. They assist already delinquent homeowners in order to prevent foreclosures. We believe the decline in delinquencies is coincidental to the decline in unemployment claims, soon to be employment gains, which should only serve to solidify the gains in home prices we have seen so far.

As we reduce our exposure abroad, we intend to look for opportunities in these markets, both developed and developing, later this year. We will be measuring the success of central banks in developing countries as they attempt to navigate soft landings, and we will be monitoring the European Union's efforts to stabilize the fiscal crises plaguing several member nations. We continue to believe the U.S. will be the best performing stock market in 2010. We established a target of 1200 for the S&P 500 in May 2009. We then increased that target to 1350 at the beginning of this year on the basis that the economy would grow in excess of 4% and corporate profits would soar 25% in 2010. We now believe our profit estimates for the S&P 500 (\$80) to be conservative, but we are not changing our target. Our sector emphasis remains focused on financials, industrials, energy, materials and technology. ■

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