



# Market Outlook

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Despite an overwhelming consensus that the U.S. is in recession, the economy grew a modest .6% in the first quarter of this year. The Dow Jones Industrials (+4.5), Nasdaq Composite (+5.9%) and Standard & Poor's 500 (4.9%) all finished the month with impressive gains that ended five consecutive months of decline. Energy led sector performance with a gain of 10.9% as oil approached \$120/barrel, while consumer staples was the worst performing sector, posting a loss of less than 1%.

We have maintained since June 2006 that the U.S. would experience a period of slower economic growth (mid-cycle slowdown) as a result of the rise in short-term interest rates from 1.0% to 5.25%. This rise in rates burst the speculative bubble in housing last summer, which then led to the current financial crisis in credit markets. The Federal Reserve responded to these events last September by aggressively lowering short-term interest rates, culminating in the most recent cut of 1/4 point this week, leaving the Fed Funds rate at 2%. We believe this will have concluded the Fed's rate cutting campaign and will mark an important turning point in the investment and economic outlook.

Most people blame the decline in home prices and the ensuing financial crisis for the stock market cor-

rection over the past few months, but the real culprit has been inflation. The stock market has been trading in a narrow range for more than a year, despite healthy corporate profits outside of the financial sector, because the nominal rate of inflation doubled due to the rise in food and energy prices. Much of this rise can be attributed to the rapid growth of developing countries like China and India, but we believe the rise in recent months has a speculative fervor similar to that which led to bubbles in tech stocks and home values.

Our optimism for the U.S. stock market stems from historically low valuations, slowing yet positive corporate earnings growth and unprecedented amounts of liquidity around the world that needs to be invested.

The weakening U.S. economy, reinforced by recession forecasts from the media and most economists, combined with a mounting budget deficit caused by the war in Iraq and lower short-term interest rates, have all devastated the value of the dollar. Commodities have long been a traditional hedge to a falling U.S. dollar, but the speculative flow of institutional and individual investment funds into this asset class is unprecedented. Nearly \$40 billion of the \$70 billion invested in the past year was put to work in the first quarter of 2008. The registration of countless investment vehicles in recent months that package combinations of everything from crude oil to grains to metals leads us to the conclusion that the entire commodity complex is long overdue for a dramatic price decline.

Commodities are now being used to speculate on

continued weakness in the dollar and the U.S. economy, as opposed to hedging other asset classes, which in turn is putting upward pressure on inflation. Despite slowing growth in Europe, concerns over rising inflation have prevented the European Central Bank (ECB) from lowering short-term interest rates, which in turn has put more downward pressure on the U.S. dollar and furthered the rise in commodity prices. We believe a reversal of this self-feeding loop began this week with a positive first-quarter GDP report that diminished both recession fears and expectations that the Federal Reserve has lowered interest rates for the last time. The dollar ended the month of April with its first monthly gain in nearly four years. We believe that there will be further evidence that the U.S. economy has averted recession and that the Federal Reserve has moved from an easing to a neutral interest rate policy, which will lead to a strengthening dollar and an unwinding of speculative positions in commodities.

Hastening the decline in commodity prices will be slower rates of growth for the developing world. We believe the correction over the past six months in the stock markets of developing countries like China and India are indicating slower economic growth in these countries in the months ahead. The Chinese Central Bank continues to raise short-term interest rates, limit loan growth and appreciate its currency in an attempt to contain inflation. China has been responsible for the majority of the world's incremental oil demand over the past several years, and its need for imported goods has helped the economic growth of many other developing countries that depend on exports. If China slows, as we expect it will, so will the rest of the developing world.

The implications of a decline in commodity prices, led by slower rates of global economic growth and a strengthening of the U.S. dollar, would be a lower rate of inflation in the U.S. and a significantly higher stock market valuation. We believe the U.S. will be the best performing of the global stock markets in 2008.

While the central banks of most countries around the world either continue to tighten monetary policy or have yet to begin lowering interest rates, we believe the Federal Reserve has successfully navigated a hard landing that will lead to slow yet positive economic growth for the remainder of the year.

The \$100 billion in tax rebate checks from the stimulus package that are being issued this month will lift disposable income and consumer spending, resulting in positive economic growth in the second quarter. The interest rate cuts by the Federal Reserve that began last September will positively impact economic growth in the third and fourth quarters of this year. Despite the fiscal and monetary stimulus, we expect home prices to continue to decline and the unemployment rate to continue to rise as the U.S. consumer embarks on a period of deleveraging that lasts several years.

This is far from an optimistic forecast for the U.S. economy other than the fact we do not see a recession in 2008. Our optimism for the U.S. stock market stems from historically low valuations, slowing yet positive corporate earnings growth and unprecedented amounts of liquidity around the world that needs to be invested. We believe an easing of inflation concerns in the U.S. will be the catalyst that ignites a sustained rise in stock prices. ■

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