



Market Outlook

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The stock market continued its ascent, which began in early March, despite a healthy dose of skepticism from bearish investors, and a consensus view that still believes the worst is yet to come. The Dow Jones Industrials (+7.3%), Standard & Poor's 500 (+9.4%) and Nasdaq Composite (+12.3%) all finished the month with impressive gains, and financial stocks (+22%) once again led in terms of sector performance (Source: Bloomberg.com).

The world is focused on the probability of a swine flu pandemic, but there is another one already here. The pandemic infecting the investment public is one of fear and bewilderment. The majority of investors, led by the same parade of misguided, book-touting pundits that dominate the airwaves, continue to focus on lagging indicators like the unemployment rate and the year-over-year decline in home prices. This is as futile as the federal government's attempt to gauge the preparedness of our banks for a worsening economic outlook with the political sham they call a "stress test," more akin to testing the levees in New Orleans one day after a 100-year flood. Meanwhile, there is an economic recovery underway! There is no better evidence of this reality than the most important leading economic indicator we know of -- the stock market. The market lows achieved earlier this year have given birth to a new bull market, with the averages having now recovered approximately 30%, sending the bears into hibernation.

A handful of keen economists have identified what are being called "green shoots" in economic activity. We believe these green shoots have deep roots in what will lead to growth by the third quarter of this year. We have maintained that a significant percentage of the unprecedented contraction in global economic activity was abnormal, in that real demand that

existed for goods and services was stifled by a forced contraction in the supply of credit. Now that credit is being restored, we believe we are on the cusp of an equally unprecedented resurgence, leading to one of the sharpest recoveries on record that few see coming. We have seen meaningful month-over-month increases in retail sales, vehicle sales and consumer confidence, but the most important development thus far is the improvement in the global Purchasing Managers Index (PMI) for manufacturing and services companies. This survey, now at a five-month high, is a broad measure of business activity that leads the upturn

in industrial production. The unsustainable liquidation of inventories in the first quarter that led to a 6.3% decline in economic growth will inevitably lead to restocking, which should result in economic expansion this summer, marking the end of the recession.

There are improvements on the housing front as well. We rang the alarm with respect to the housing bubble in December 2005, pointing to the initial month-over-month declines in median home prices and existing home sales, while the masses were still reveling in the annual price increases that continued until

the summer of 2006. We now see similar developments, but in a different light. Two leading home-price indexes report that median home prices have risen month-over-month for two consecutive months, and we believe prices may be bottoming in the most distressed markets. New home inventories have rapidly declined to a level not seen since the early 1970's, leading us to the conclusion that both existing home sales and new home starts have bottomed.

We think the next catalyst for higher stock prices will come in the form of better than expected employment data. The unemployment rate may be the figure that catches all the headlines, but it is the weekly unemployment claims num-

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ber that more accurately predicts a change in trend. The steady decline in layoff announcements indicates to us that claims may have peaked. If this is true, then the market will be taken by surprise with a significant decline in one of the upcoming monthly job loss reports.

This is not to say the coast is all clear. We will continue to see job losses this summer from vehicle supply firms when General Motors shuts down production for nine weeks. The deterioration in commercial real estate will likely continue well into 2009. The number of foreclosures and losses on consumer loans will continue to mount. Yet it is the rate of change that matters to markets most, not the absolute numbers, and we believe the positives will gradually outweigh the negatives. The skeptics will soon fan fears of inflation as the economy reflate, and while inflation has been a nemesis for stock prices in decades past, we are starving for it today, for inflation is a byproduct of growth! Few remember the last deflationary period this country experienced, like the one we are faced with today, because it was in the 1950's. This was a period during which inflation was good for stocks.

The markets lead us to believe the economy is at an inflection point. We stated last November that while investors were embroiled in the most devastating financial crisis in modern history, they were at the same time being handed the investment opportunity of a generation. We went on to say we may be embarking on one of the best five-year periods for U.S. stock market performance in history. I imagine most still think us foolhardy. Our upside target for the S&P 500 this year is 1200, which would be a 30% rise from today's levels, marking the point at which the credit crisis ensued last September. We expect the road to be bumpy, with several corrections of 10% or more along the way, but unlike last year when rallies were opportunities to sell, corrections will be viewed as opportunities to buy. Trillions of dollars remain on the sidelines earning negligible returns that provide ample fuel to meet our target.

The sectors that suffered the worst declines last year were those most levered to economic growth. Should the economy be at an inflection point, these are the sectors that

should emerge as the best performers in 2009. We believe more defensively oriented sectors like healthcare, consumer staples and utilities will lag this year, while those more levered to an improvement in the economic outlook like technology, industrials and consumer discretionary will lead. The most controversial sector is clearly the financials, yet we think they have the potential to lead the market higher throughout the year.

The public has been led to believe by lawmakers, pundits and fear-mongering analysts that our banking system is insolvent and that some of our largest financial institutions must be nationalized. How then could our nation's largest banks have reported profits in the billions during the first quarter of the year? The skeptics, in denial of their own flawed analysis, blamed these profits on a boom in mortgage refinancing, an explosion in net interest margins and improvements in asset values resulting from mark-to-market accounting. Evidently, it is fine to mark down the value of assets that banks hold, but it is an accounting gimmick when they mark them back up. As for mortgage refinancing and growth in net-interest margins, this is what banks do! Questioning their profits on this basis is like saying the only reason the Yankees lost their home opener is because the other team scored more runs. We think bank profits will continue to rise as deposits increase, loan volume increases, asset values rise and loan losses gradually level off. The potential upside from valuation levels more consistent with insolvency is significant enough to result in financials being the best performing sector in 2009.

Eleanor Roosevelt once said, "Great minds discuss ideas; average minds discuss events; small minds discuss people." It is no wonder that popular opinion is so often misguided, given that the noise we rely on for news, which reverberates 24/7, is usually fixated on events and people that really don't matter. Successful long-term investing is dependent on developing ideas about trends likely to unfold in the economy and markets over time. These ideas take shape in the form of investments that collectively define an investment strategy, which if soundly grounded, ultimately determine success. ■

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