



2011 Market Outlook

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We have adopted a far more cautious tone over the past three months. That caution has yet to be rewarded, as stock prices continue to creep higher, pushing through the February highs that we believed would mark a longer lasting peak. The Dow Jones Industrials (+3.9%), Standard & Poor's 500 (+2.9%) and Nasdaq Composite (+3.3%) all finished the month of April in positive territory. Healthcare led sector performance with a gain of 6.2%, while the financial sector was the worst performer, posting a loss of less than 1% (source: Bloomberg.com).

We began to temper our optimistic outlook in February as commodity prices continued the surge that began last fall, despite what appeared to be slowing rates of global economic growth. Domestic consumer price inflation has risen 2.7% over the past year due to the rise in food and energy prices, but at a 4.7% annualized rate over the past six months and at a 6.1% annualized rate in the first quarter of this year. At the same time, real economic growth slowed from a rate of 3.1% in the fourth quarter of last year to just 1.8% in the quarter just ended. The unsettling word used to describe this economic phenomenon, which defined the decade of the 1970's, is stagflation. A slow or declining rate of economic growth combined with rising rates of inflation is now only a faint memory, if one at all, for most investors. The Federal Reserve tells us that the surge in the consumer price index (CPI) is "transitory," while the consensus view of economists is the expectation that economic growth will snap back to a rate of 3% or better through the remainder of this year. Investors, whether they be sipping from the QE2 punchbowl or bathing in it, seem to be hanging their hats on these forecasts without question. We, on the other hand, while not forecasting a prolonged period of stagflation, do sense a more difficult journey ahead than what we have seen since the onset of the Fed's second quantitative easing program last September.

We believe economic growth will fall below consensus estimates in the second and third quarters as we work through a multitude of headwinds on both international and domestic fronts.

We wrote about similar concerns we had for stock prices exactly one year ago in the Market Outlook. The S&P 500 had risen 9% during the first four months of 2010, just as it has during the first four months of 2011. We stated last May that, "Our greatest concern has been the potential for a financial crisis in Europe, and the complacency with which investors and markets have addressed such a possibility." The sovereign debt crisis that followed roiled financial markets throughout the summer months. We also stated that, "As 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. We see the S&P 500 having strong support near the 200-day moving average, which approximates 1100, and a decline from the recent highs (1219) to that level would be a healthy 10% correction." The correction that followed approximated 16%. Today we see a similar complacency over a different set of circumstances, and the possibility for yet another correction, albeit more modest than what we saw last summer.

We believe economic growth will fall below consensus estimates in the second and third quarters as we work through a multitude of headwinds on both international and domestic fronts. We have previously discussed the impact that negative developments in Europe and Japan are likely to have on global growth, but what is occurring on the domestic front has us more concerned today. We thought that economic activity would have been far more balanced across the socio-economic spectrum within the United States at this point in the recovery/expansion with respect to income and spending figures. That would have buffered the risks we now see with regard to inflation. This has not happened. Chairman Bernanke's monetary policy experiment of trickle down economics through the wealth effect of stock market gains has a plug in the drain. The trickle down part has yet to show up in the data. Consumer spending rose at a rate of

2.7% in the first quarter, the greatest contributor to economic growth, but the only consumers we see spending are those with stock portfolios and household incomes in excess of \$100k. Now the rate and quality of spending is starting to slow, which doesn't bode well for consensus expectations of economic growth.

Retail sales increased .4% last month, which was the ninth increase in a row, but when we exclude gasoline sales, the increase was just .1%. Wal-Mart's CEO commented last week that, "our shoppers are running out of money." Wal-Mart averages 140 million shoppers nationwide on a weekly basis. While we are seeing job creation numbers we anticipated, the quality of jobs and the incomes associated with those jobs is not inspiring. McDonald's received one million job applications last month for 50k openings and hired 62k. Is it any wonder we haven't seen any growth in wage or salary income? And now gas prices are once again approaching \$4/gallon, which brings us back to the inflation Chairman Bernanke calls "transitory."

Gas prices are surging commensurate with the rise in oil prices. Chairman Bernanke and Wall Street point to growth in the developing world as the root cause. Republicans say we must explore and produce more at home. Democrats are convinced the rise in price is the result of fraudulent price manipulation and speculation. President Obama wants to form a commission that will conduct an investigation. The media is once again vilifying the big oil companies. We are still waiting for lawmakers to have the "adult conversation" that never took place in 2008. Perhaps the reason they refuse even to address what we see as the root cause is that they would be taking dead aim at the latest money making enterprise for Wall Street banks along with all the future campaign contributions from the industry that they depend on to hold office. Revenues from trading in commodity markets accounted for nearly 10% of total revenues for the industry last year.

We believe commodity prices have soared in recent months due both to speculative and long-term-oriented investment

flows into futures contracts. These activities are legal, because Congress opened the floodgates to these investment flows through legislation it passed 10 years ago. Perhaps we would have addressed this systemic risk back in 2008 if commodity prices, led by oil, had not collapsed along with other financial assets during the credit crisis that hit just weeks after oil peaked. We are now concerned that we are in the midst of a repeat of the summer of 2008. This latest boom won't result in a bust until the price increases destroy so much demand that the investments flows reverse, or public enlightenment and corporate outrage force the hand of lawmakers and the Commodity Futures Trading Commission to place limitations on Wall Street's latest profit machine.

Chairman Bernanke needs to pray we are wrong, for it is not just food and energy that are seeing a so-called "transitory" rise in price. As the home ownership rate is declining, the demand for rental homes and apartments is increasing, and rents are beginning to rise substantially. Gas prices are on pace to exceed the \$4.11/gallon highs we saw three years ago, which would equate to more than \$100 billion in additional cost for consumers this year, more than negating the entire 2% employee payroll tax cut for 2011. We see real incomes for the vast majority of American households continuing to decline, and we expect the nominal rate of inflation to approach 5% this summer, slowing dramatically what has been the most significant contributor to growth—consumption.

We suspect that QE2 is temporarily inoculating the market from the foreboding developments we see, and devaluing stock price performance as a leading indicator. Still, we expect investors to start factoring into stock prices these risks to growth and corporate profitability prior to the current program's end in June, given that a third round of quantitative easing seems politically untenable. What might convince us we have come to the wrong conclusions about the market? A halt in the rise of commodity prices prior to the resultant level of demand destruction that will ultimately stall economic growth. ■

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