



Market Outlook

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The string of seven consecutive monthly gains in stock prices ended in October over concerns that the economic recovery is losing momentum, despite a report that the economy grew 3.5% last quarter, signifying that the recession is likely over. The Standard & Poor's 500 (-1.9%) and Nasdaq Composite (-3.6%) both edged lower, while the Dow Jones Industrials finished the month unchanged. Energy led sector performance with a gain of 3.2%, while the financial sector was the worst performer, posting a loss of 6% (source:Bloomberg.com).

Concerns that the recovery had stalled emerged following reports that weekly unemployment claims increased, consumer spending in September declined for the first time in five months, and consumer confidence slid in October. These reports cast doubt on the sustainability of the recovery, which many believe to be mostly driven by government stimulus. Fueling the negative sentiment were fears that the end of the home-buyer tax credit in November will bring a halt to the improvements in home prices and sales. Cynics argue that when the government's stimulus efforts run their course, the economy will slip back into recession. Yet at the same time the index of U. S. leading economic indicators rose in September for a sixth straight month.

The market correction underway, similar to the ones we

saw in July and September, is a correction in confidence and not economic fundamentals. While a weekly figure for first-time unemployment claims did rise, the four-week moving average declined for an eighth consecutive week to the lowest level in nine months. The decline in consumer spending for September was due to the end of the cash-for-clunkers program. Consumer spending actually rose on a monthly basis when auto sales are excluded from this artificially inflated figure. In fact, the current level of chain-

store sales are on pace to far exceed the National Retail Federation's projection for a year-over-year decline in November and December. We expect Congress to approve an extension and expansion of the home-buyer tax credit this month that will further support home values and sales through April of next year.

We can't deny investors' concerns and the public's dismay, given the short-sighted policies coming out of Washington and the politicization of the economic stimulus funds to date. The vast majority of the billions of dollars approved for investment sit idle. What's the excuse?

The original plan was to spend the funds over a two-year period. Why two years? It is no coincidence that the mid-term elections will be held approximately two years after the economic stimulus plan was enacted. Meanwhile, programs designed to induce consumption, like cash-for-clunkers and the home-buyer tax credit, simply steal future demand so as to create the illusion that the sta-

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tus quo is better than reality dictates. These misplaced priorities are clearly demonstrated by the Obama administration's announcement to send \$250 checks to social security recipients for a total of \$13 billion, compared to the \$3.4 billion made available for projects aimed at modernizing the nation's power grid. The \$250 checks may buy lots of \$10 toys at Walmart come year-end, and even fewer votes for incumbents in next year's mid-term elections, but they do little to support job growth or the long-term investments we need to stay competitive in the global economy. Give a social security recipient a check for \$250 and you feed him for a week. Create a job and you feed a middle-class family for a lifetime.

The sustainability of this recovery and continuation of the bull market underway depends predominately on one thing – employment. We still find more reasons to be optimistic than pessimistic, because our focus is on what the jobs data will look like six months from now rather than on what it was last month. Ironically, the rise in consumer spending (ex-autos) that contributed to a 3.5% advance in GDP last quarter is not the driver of growth or employment upon which our bullish outlook is dependent. That driver has yet to materialize. This is a profits-led recovery. The surge in corporate profits over the past nine months is unprecedented for a recessionary period. Therefore we should be focusing on the inevitable revival of corporate spending that will lead to job growth. Companies reduced labor costs and consumers cut spending earlier this year well in excess of what the severity of the recession in economic activity would normally dictate. This is because practically everyone assumed the recession was really a depression.

As home prices have stabilized and financial markets have recovered, consumer net worth has increased nearly \$5 trillion over the past year. It has now returned to a level relative to disposable income consistent with the historical average that predates the stock market and housing bub-

bles of the past decade. We know that a rise in consumer net worth leads consumer spending by approximately six months, which bodes well for sustaining current spending levels as we move forward. Furthermore, we believe that earlier this year the 90% of consumers who are still employed cut back on spending more than necessary for fear their net worth would continue to decline. The dissipation of their fear explains the incremental rise in spending (ex-autos) from depressed levels over recent months and runs counter to the argument that the increase was stimulus induced.

Under the same misconception, corporations reduced expenses and cut employment well in excess of the peak-to-trough decline in economic growth (3.7%) in preparation for what they thought might be a depression. As a result, productivity and profits have soared and capital spending is down to its lowest level as a percentage of GDP in decades. Corporate revenues inevitably rise when the economy begins to expand, forcing companies to increase spending on capital equipment and to hire more workers.

Temporary employment continues to improve and the rate of decline in unemployment claims now exceeds the pace set in the previous two recoveries (1991 and 2001). Manufacturing employment surveys and the Institute for Supply Management's payroll indicators are all moving higher. The current trajectory of the data leads us to believe we will see job growth by year-end, but the unemployment rate will still exceed 10% in the near term. An unemployment rate of 10% isn't much different than the current 9.8%, but there will be a psychological impact on the public and undoubtedly visions of pink slips for politicians come next November. Herein lies the silver lining.

The unemployment rate exceeded 10% just two months prior to the mid-term elections in 1982, and the Republicans suffered significant losses in the House and Senate. We believe a 10% unemployment rate today will force the Obama administration to surrender political gamesmanship

and accelerate an initiative Democrats intended to use prior to next year's mid-term elections – a new jobs tax credit for businesses. We believe this would garner overwhelming support from both sides of the aisle and serve to speed up the improvement in employment that is already underway.

Another significant driver of economic and employment growth in coming quarters has yet to unfold. Businesses have continued to reduce inventories despite the improvement in sales activity. While industrial production is increasing, it is not increasing at the rate of end demand, so inventory-to-sales ratios are still declining. Businesses will be forced to bring inventories in line with sales over the next several months, which should boost economic growth more than most expect, further improving employment.

The trend in leading indicators that measure economic health six months from now collectively point to an improvement in the coincident and lagging indicators (unemployment rate) that the media emphasizes and the general public relies on to make emotionally based investment decisions. We believe these leading indicators will peak during the second quarter of 2010, at which point we are likely to temper our bullish outlook. In other words, when the unemployment rate is finally beginning to fall from its peak, and weekly unemployment claims (leading indicator) have bottomed, the majority of investors will finally feel comfortable taking on risk. From that point moving forward, stock market gains are likely to be muted relative to the gains we will have seen over the previous year. Investors scoffed at the idea of investing in stocks last April as leading indicators began to rise month-over-month, but

they are likely to be euphoric several months from now just as these indicators peak. We believe we are beginning the seventh-inning stretch of the historic rise in stock prices that began in March, and though we expect the breadth of participation to narrow in coming months, our upside target for the S&P 500 remains 1200. When the facts change, so will our outlook.

Our bottom line is that the economy is on the mend. The equation that supports our bullish outlook is unprecedented levels of liquidity plus historically low interest rates combined with elevated skepticism equals higher asset prices. Investors still hold more than \$3.5 trillion in money market funds, which is nearly twice the historical average relative to the value of the stock market. The Federal Reserve is highly unlikely to raise short-term interest rates until the unemployment rate begins to decline, which we believe won't occur until next spring. We can't think of a bull market more loathed by the investor public than the one that began in March. Investor sentiment remains extremely subdued as evidenced by the flow of funds into stock and bond mutual funds. While investors directed more than \$200 billion into bond funds during the first eight months of the year, there has been a net flow of just \$15 billion into stock funds. This is all the evidence we need to know that most investors have not subscribed to the recovery thesis. The market should find its footing once again in November, following what may be a 10% correction from the October highs, but we would view this as yet another buying opportunity as the market averages achieve new highs before year-end. ■

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