



Market Outlook

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Stock prices continued the surge that began two months ago as investors discounted the probability of a power shift in Washington and a second round of bond purchases by the Federal Reserve. With or without these positive catalysts for financial markets, we continue to see improvement in underlying economic trends. The arguments supporting a negative outlook are running thin. The Dow Jones Industrials (+3.0%), Standard & Poor's 500 (+3.7%) and Nasdaq Composite (+5.8%) all finished the month with impressive gains. Materials led sector performance with a gain of 6.6%, while the telecom sector was the worst performer, posting a loss of less than 1% (source: Bloomberg.com).

Republicans are likely to win a majority in the House of Representatives, while Democrats retain control of the Senate. The significance a balance of power would have for investors is the resulting improvement in business confidence that could ultimately translate into more robust payroll job growth. Under a divided government corporate leaders would feel less threatened by the potential for more onerous regulations, the possibility of tax increases and the costs associated with pending healthcare legislation. There is also the possibility that both political parties take ownership of the path that lies ahead and move toward the center to promote pro-growth initiatives, but we believe that Federal Reserve policy will be a more influential determinant of future market performance.

There has been relentless debate in recent weeks amongst market pundits about the need for another round of quantitative easing, the varying approaches to its implementation, and the amount of debt that will ultimately be purchased.

These debates, in our view, are irrelevant. What is important from an investment standpoint is that the commitment by the Federal Reserve will be open-ended and substantial up to the point that it believes it has achieved its Congressional mandate of full employment and price stability. The Fed has indicated this to be an unemployment rate of 5% and a core inflation rate approaching 2%. To accomplish this goal, we believe the Fed's intentions are two-fold: first, to inflate stock prices in an effort to ignite a wealth effect that will boost consumer and business confidence, and second, to weaken the dollar with the objective of boosting exports and corporate profits. Both should stimulate economic growth and job creation.

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Each of the previous episodes of quantitative easing that occurred in Japan, the United Kingdom and the United States coincided with significant increases in both stock prices and the rate of economic growth. One notable difference is that each of the previous periods occurred coincident with economic contractions, while the one to be announced by the Federal Reserve this week will be implemented during a period in which the economy is reaccelerating. The desired effect in the near term may be even more pronounced as a result, but there could also be unintended consequences. If the Fed is underestimating the strength of the economy, as we believe it is, then the deflation it is attempting to thwart could lead to a rise in commodity prices reminiscent of 2008. We believe history is destined to repeat itself.

The initial estimate that the economy grew at an annualized rate of 2% in the third quarter was uninspiring for most investors, but we continue to be encouraged by the steady progress. During the last two recoveries (1991 and 2002)

economic growth temporarily slowed to less than 2% for two quarters before reaccelerating to twice that rate in the year that followed, and we anticipate a similar scenario unfolding again. The election results we expect, combined with the quantitative easing likely to be implemented, would serve to turbo-charge our forecast. Consumer spending increased at the fastest pace (2.6%) since the fourth quarter of 2006 and was the largest contributor to growth, yet most investors assume the consumer to be the weakest link in the economy. The greatest detractor from the headline number was again trade, which subtracted 2% from GDP growth. However, we expect trade (exports) to be the key driver of economic growth as the newest expansion progresses.

A gradual rebalancing of power between the developed and developing world is occurring in the global economy. Developing countries are now home to more than 80% of the world's labor force. Their economies have been growing at a significantly faster rate than those of the developed world, and their workers have realized far more rapid increases in wages and compensation. A middle class of consumers in developing countries may be in its infancy, but aggregate consumer spending in the developing world now exceeds that of the United States. The Chinese, which are leading the transformation, are on pace to purchase more than 17 million vehicles in 2010 compared to less than 12 million in the United States. The significance of this rebalancing is that developing world currencies should slowly appreciate in coming years, while developed world currencies depreciate, to more accurately reflect the growth rate differentials. A measured depreciation of the dollar should lead to a steady increase in U.S. exports to the developing world, in addition to rising corporate profitability and job creation. This brings us back to the subject of quantitative easing. The Federal Reserve is simply accelerating a process that in our view is already underway.

Two years ago, in the midst of the financial crisis, we made what most considered at the time an outlandish forecast for the U.S. stock market—"We believe we may be embarking on one of the best five-year periods for U.S. stock performance despite the dire outlook." Since that time the S&P 500 has risen approximately 23%. Our call would have been more prescient had we waited five months. The S&P 500 has risen more than 70% from the March 2009 lows. We still feel confident in our prediction with three years left to go, because common stocks remain the most undervalued, unloved and under-owned asset class in our view. This doesn't mean we have blind faith in the stock market, and we continue to devote ourselves to a tactical approach with respect to emphasizing asset classes, but at this stage we believe domestic and international equities will outperform all other investment alternatives.

We are all compelled to invest more following a substantial increase in prices. The S&P 500 has soared nearly 14% in two months time from the lower end of the summer trading range without as little as a 2% correction. The markets are extended on a technical basis, yet Wall Street professionals are all looking for the same 5% correction to increase equity exposure, which leads us to believe any correction will be shallow and brief. We do see one potential pothole between now and year-end that could resolve the current overbought condition with a temporary decline in stock prices. Congress will return to Washington for one week in mid-November following the mid-term elections. The financial markets will be acutely focused on legislation to extend the Bush tax cuts. We do not believe the tax cuts will be extended during this lame-duck session, and likely won't be addressed until December, but we do expect the tax cuts to be extended for at least one year. This should be another positive market catalyst as we begin 2011, but the risk of political gridlock in two weeks' time is highly probable. ■

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