FULLER
ASSET MANAGEMENT, LLC
Charting a Course for the Future

7150 East Camelback Road · Suite 444, Scottsdale, AZ 85251
Tel: 480.477.8155 Fax: 480.477.8157
2 Wisconsin Circle · Suite 700, Chevy Chase, MD 20815
Tel: 240.235.5034 Fax: 240.235.5035
www.fullerassetmanagement.com

OCTOBER 2007
VOLUME 3 • NUMBER 10

Market Outlook

LAWRENCE FULLER
Managing Director and Portfolio Manager

Commodity prices soared, the dollar plunged, and the stock market staged a huge rally following the 1/2 point cut in short-term interest rates by the Federal Reserve on September 18. The major market averages have now recouped nearly all of the losses incurred from the correction that began in July. The Dow Jones Industrials (+4.0%), Nasdaq Composite (+4.0%), and Standard & Poor's 500 (+3.6%) all finished the month in positive territory. Energy led sector performance with a gain of 8.0%, while the consumer discretionary sector was the worst performer, posting a loss of 1.0%.

We believe the most critical question facing investors today is whether or not weak consumer spending and a deteriorating housing market will drag the US economy into recession in 2008 and bring the bull market in stocks that began in 2003 to an end. We will review this debate from both sides and conclude with what we believe to be the most likely outcome.

The financial crisis in the credit markets may be over, but the woes for the US economy have only begun. Headlines for the housing, auto and retailing industries continue to worsen, but the unemployment rate remains near a historic low and consumer spending has remained firm. We think things are about to change. News that the economy lost 4,000 jobs in August took the market by surprise, but we think October's employment report will be far more significant. Government reports on employment data have been padded due to a faulty calculation method for months, but the Bureau of Labor Statistics (BLS) monthly employment report due on October 5th may inject a dose of reality into these statistics. The BLS will report its final tally for job gains from March 2006 through March 2007. This revised figure will adjust the "guesstimate" of how many jobs were created by small businesses. We expect a considerable reduction in employment growth. We believe the unemployment rate will rise well above 5% next year.

Using the early 1990's as a precedent, we expect home prices to decline for another two years, and this negative wealth effect, combined with rising unemployment, will increasingly weigh downward on consumer spending. Even more troubling was last week's report of new data on mortgage equity withdrawal (MEW). This report revised the amount of home equity withdrawn upward by one trillion dollars! The amount totaled a staggering $500 billion in the second quarter of this year alone. This tells us that the outlook for future consumer spending is far more negative than the consensus view. Consumer debt as a percentage of household income is currently near its all-time high, and consumers continue to withdraw equity from their homes, yet consumer spending growth over the past two quarters was the weakest since the 2001 recession. As the volume of adjustable-rate mortgages due to reset over the next 12 months rises along with delinquencies and foreclosures, the rate of growth in consumer spending will approach recessionary levels.

The financial crisis in the credit markets may be over, but the woes for the US economy have only begun.

The booming growth in developing countries like China and India has resulted in a meteoric rise in commodity prices. The commodity price indices rose nearly 15% last month, with oil prices reaching an all-time high of $84/barrel. What the developing countries buy they inflate. Higher energy and food prices will continue to weigh heavily on US consumer purchasing power in the months ahead.

Despite this bleak outlook for the US consumer and those segments of the US economy dependent on the resiliency of consumer spending, there are several positive aspects to the current investment landscape. One of the benefits of strong developing economies is that what they sell or export to us, they deflate. This has resulted in a very low level of core inflation in the US, which opens the door to additional rate cuts by the Federal Reserve at a time they are desperately needed. We expect the Fed to reduce short-term interest rates

at each of its next three meetings, resulting in a Fed Funds rate of 4% by the first quarter of 2008.

If we consider rate cuts by the Federal Reserve to be the spark that ignites the market, global liquidity is the fuel that drives asset prices higher, and it is abundant. This liquidity is coming from foreign central bank reserves, corporate balance sheets, and record profits for oil-exporting countries. The growth in global money supply is over 10%, while US money supply growth continues to accelerate at a 12% rate. History shows that money growth (10%) in excess of the rate of economic growth (2-3%) ends up moving into financial assets.

US corporate balance sheets have never been better, with liabilities as a percentage of assets near 20-year lows. This enables companies to buy back stock, increase dividends, make acquisitions and increase capital spending. The weakening US dollar improves the competitive stance of US companies in the global economy by making their products and services less expensive than their foreign competitors. This leads to stronger exports, which in turn improve the trade deficit and bolster domestic economic growth. History has shown that when the currency of a country goes into a prolonged downtrend, the stock market outperforms every financial asset class in that country. We believe that the bleak outlook for real estate in the US and the credit crisis impacting the fixed-income markets make the US stock market the only logical investment option for the huge amounts of liquidity floating throughout the global financial system.

In conclusion, we believe that recessionary numbers for housing and consumer spending will be offset by an improving trade deficit, due to a weaker dollar and an improvement in capital spending by corporate America, averting the technical definition of a recession (two consecutive quarters of negative real economic growth). The only periods when the economy has fallen into recession during previous consumer-led slowdowns occurred when corporate spending also turned negative. The stock market will discount the prospect for future Fed easings, slower yet positive corporate earnings growth, and low inflation, with expanding multiples. History is on our side. The S&P 500 has realized an average gain of more than 12% in the six months following the first cut in rates by the Federal Reserve since 1970.

Our enthusiasm for the stock market's upward momentum will be tempered significantly as we approach what we believe to be fair value in the months ahead. We have a target of 1700 for the S&P 500 index, which would result in a 10% rise from current levels. We believe this is achievable over the next six to nine months.

We do have several concerns longer term. Developing market growth will eventually slow from an unsustainable pace, which will impact the profitability of US industrial, energy and materials companies, as well as the improvement in our trade deficit. Additional Fed easings combined with a weakening dollar and rising commodity prices will inevitably lead to inflation concerns, which may result in higher long-term interest rates and borrowing costs for consumers. Finally, we are not certain that consumer spending will recover and the housing market will stabilize in response to Fed easings before the engines of global growth slow and we are faced with higher rates of core inflation and long-term interest rates. We will be monitoring these possibilities closely in the months ahead.

We remain fully invested in our portfolios with an emphasis on growth over value investment styles, and large over medium and small company size. We are overweight the energy, industrial, materials and technology sectors in our large-cap growth equity portfolio. We believe these sectors will benefit from a continued rise in commodity prices, a weakening dollar, and low correlation with consumer spending and the housing market. These sectors are also among those with the greatest foreign sales exposure. We expect the healthcare sector to remain under pressure, due to the political risk of Democratic-led proposals to reform the industry. The consumer discretionary sector will remain under significant pressure as consumer spending continues to slow.■

Fuller Asset Management, LLC (FAM) is an SEC registered investment advisor. FAM and its representatives are in compliance with the current notice filing requirements imposed upon registered investment advisers by those states in which FAM maintains clients. FAM may only transact business in those states in which it is noticed filed, or qualifies for an exemption or exclusion from registration requirements.

This newsletter is limited to the dissemination of general information pertaining to its investment advisory/management services. Any subsequent, direct communication by FAM with a prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the prospective client resides.

For additional information about FAM, including fees and services, send for our disclosure statement as set forth on Form ADV from FAM using the contact information herein. Please read the disclosure statement carefully before you invest or send money.

©2007 Fuller Asset Management, LLC. All rights reserved.