FULLER
ASSET MANAGEMENT, LLC
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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

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Market Outlook

LAWRENCE FULLER
Managing Director and Portfolio Manager

The stock market continued to decline from the record highs set on July 19, culminating in a 10% correction in the major market averages by August 16. We believe this correction is over, and that the averages will reach new highs by year-end. The Dow Jones Industrials (+1.1%), Nasdaq Composite (+1.9%), and Standard & Poor's 500 (+1.3%) all finished the month with gains. Technology led sector performance with a gain of 2.7%, while the materials sector was the worst performer, posting a loss of .8%.

The severity of the sub-prime mortgage disaster was first realized when two Bear Stearns hedge funds invested in mortgage-backed securities suffered huge losses. Since then the contagion has spread across the globe, resulting in billions in losses. Central banks around the world have injected huge amounts of liquidity into financial markets to maintain stability. How did this financial crisis come to pass?

> Despite the ongoing turmoil in the credit markets and its impact on economic growth, corporate profits remain strong, inflation is easing, bond yields are falling, and global liquidity is explosive.

High-risk (sub-prime) loans were originated by overzealous and in some cases unscrupulous lenders in a business void of regulation. These lenders facilitated speculation in the housing market, leading to artificially inflated home values. Borrowers capitalized on rising home prices by extracting equity from their homes, overextending their purchasing power, and destroying their balance sheets.

In the same manner, mortgage-backed securities called collateralized debt obligations (CDOs) were originated by ambitious and in most cases careless Wall Street firms during a period when rating agencies offered editorial opinions as opposed to fundamental analyses. Wall Street packaged high-risk (sub-prime) loans into CDOs with bogus ratings on investment quality provided by rating agencies, facilitating speculation in these securities. Hedge funds capitalized on these questionable credit ratings by over-leveraging their portfolios with these securities. As delinquencies and foreclosures began to mount, this house of cards collapsed, leading to a re-pricing of risk throughout the global stock and bond markets.

The most critical question facing investors today is whether the unfolding financial crisis in the credit markets will drag the U.S. economy into recession, or whether the U.S. economy will simply slow down, then reaccelerate and continue the current expansion in 2008. We believe the Federal Reserve will answer this question for us at its next meeting on September 18. The probability of either scenario will be determined by how aggressively the Fed responds with monetary policy to the headwinds facing this economy in the months ahead.

Sub-prime loans will continue to default at record levels over the next year, and the investors that own securities holding these loans will continue to suffer losses. Borrowing costs for consumers and many corporations will continue to rise as the financial system de-leverages and re-prices risk. Higher borrowing costs will slow the rate of private-equity buyouts, stock buybacks, and earnings growth. The near elimination of sub-prime and Alt-A (low documentation/stated income) loan availability, which accounted for 40% of mortgage originations last year, will dramatically reduce demand for housing. Many potential home buyers will no longer qualify for financing under newly implemented banking regulations, and many homeowners who face adjustable-rate resets

over the next 12 months will be unable to refinance. All of these factors will put significant downward pressure on home values over the next several years.

We believe the Federal Reserve will acknowledge the downside risks to economic growth and the potential for lower employment growth by lowering the Federal funds target rate 1/4 of a percentage point at each of its upcoming meetings until the funds rate reaches 4% in the first quarter of next year. The consensus estimate for economic growth in the second half of this year is an overly optimistic 2.6%. We think it will be closer to 1.5%. Consumer spending, which accounts for two-thirds of economic growth, is on track to be as weak as it was during the last recession. In October the Bureau of Labor Statistics (BLS) will be revising its method of estimating small business job growth. We believe this revision will likely negate the majority of new jobs supposedly created by small businesses over the past year.

The Fed funds rate currently stands at 5.25%, but nominal economic growth has run at a 4.3% pace over the past year, meaning that the Fed funds rate is restrictive. The Fed must lower short-term interest rates below the rate of economic growth to provide stimulus, hence our forecast for a 4% Fed funds rate by the first quarter of next year.

While there are clearly similarities between the current slowdown and the one that led to recession in 2001, we believe a better comparison can be made at this juncture to the mid-cycle slowdowns that occurred during the expansions in the mid 80's and 90's. Financial crises are common during periods of slowing economic growth that result from Fed tightening cycles. Inflation concerns forced the Federal Reserve to raise interest rates following the recoveries that began in 1983 and 1991, and the economy slowed while inflation eased in 1984 and 1995. A financial crisis soon followed (Continental Illinois bankruptcy and banking system collapse in Mexico) and the Federal Reserve lowered interest rates in response, leading to a reacceleration in economic growth and tremendous stock market gains.

Our bullish market outlook is dependent on the monetary policy forecast we have outlined. The probability of recession will rise dramatically if the Fed is not preemptive on September 18. We believe the Fed will respond with a rate cut. The stock market should discount the prospect of multiple Fed easing, as well as the potential for a reacceleration in economic growth, by reaching new highs by year-end.

Despite the ongoing turmoil in the credit markets and its impact on economic growth, corporate profits remain strong, inflation is easing, bond yields are falling, and global liquidity is explosive. Strong developing economy growth in combination with a weak dollar is improving our trade deficit, helping offset the decline in domestic growth. The cash on corporate balance sheets is near 20-year highs, and corporate insiders are buying their own stocks at a record pace.

We believe the stock market has fully discounted the financial crisis that we first discussed in our July 1st Market Outlook. We used the recent market correction to increase equity exposure in our portfolios with an emphasis on high quality, large multi-national companies that are leveraged to the global economy and that will continue to benefit from a weak dollar. We are now overweight the technology sector, which we feel will benefit from easy year-over-year earnings comparisons, low valuations, and an upturn in capital spending by corporations.■

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