



Market Outlook

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As the price of oil continued to decline from its recent all-time high, the stock market built on the gains achieved since the lows reached in mid-July. The Standard & Poor's 500 (+1.2%), Dow Jones Industrials (+1.5%) and Nasdaq Composite (+1.8%) all finished the month of August in positive territory. Consumer discretionary stocks led sector performance with a gain of 7.0%, while materials were the worst performing sector, posting a loss of 2.8%.

We have believed that accurately predicting whether or not the U.S. economy would slip into recession was the critical factor in determining stock market performance this year. We have long maintained that the U.S. economy would avoid recession in 2008, based on our belief that the monetary and fiscal policy responses to the financial crises in housing and credit markets would be successful. In light of this outlook, we were confident that the stock market would recover from its March correction lows and resume the bull market that began in 2003. What we did not account for was the speculative surge in commodity prices, led by oil, which ran counter to clear signs of weakening demand and slowing global growth. This factor alone drove the rate of inflation (CPI) to a 17-year high of 5.6% in July, further depressing stock prices to new lows reached on July 15th.

After reassessing our economic outlook, we are now more optimistic on the stock market than we were before,

despite the unanticipated decline this summer that moved stocks into bear market territory (-20%). The greatest trick the stock market repeatedly plays on investors is convincing the vast majority of them that prices have nowhere to go but down, just as they bottom and begin a sustained move higher. These inflection points always coincide with

a daily drumbeat of negative news telling us everything about why we are where we are today, but little about what to expect tomorrow. Today's concerns revolve around falling home prices, weak consumer spending trends, and rising unemployment and inflation. The bearish camp is convinced we are either in or headed for recession.

If we step back from the negative news and view the economic and market landscape from a longer term perspective, today's headlines can be viewed as positives for tomorrow's stock market returns.

The rate at which home prices have been falling month-over-month has declined throughout this year, along with the rate of delinquencies and foreclosures. The healing process in housing is well under way. Consumer spending over the past year is the weakest it has been since the end of the 1990 recession, and consumer confidence has fallen to levels seen only in 1990, 1980 and 1974. What may surprise most investors is that the stock market (S&P 500) recorded gains in excess of 30% in each of the 12-month periods after reaching similar historic low readings in consumer confidence. The unemployment rate climbed to 5.7% last month after jumping by a full one-half of 1% in

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the month of May. This was only the 12th time in the past 50 years that the unemployment rate has risen by one-half of 1% in a single month. In the year that followed all 11 previous occurrences the S&P 500 rose by at least 17% and on average 26%.

We believe the recent 17-year high in the rate of inflation will shift from a headwind to wind in the sails of the stock market moving forward. The speculative bubble in commodities has burst. Oil and gold have both violated technical up trends that date back to 2003. The developing countries, led by China, that served as the engines of global growth over the past five years are running out of gas. The impact of rising short-term interest rates and commodity prices, coupled with slowing exports to the U.S. and Europe, is slowing growth in these countries. At the core of the U.S. inflation problem are rising commodity prices, led by oil. As the price of oil declines, the rate of increase year-over-year narrows, and the rate of inflation will fall. Lower inflation readings in the months ahead will lead to higher stock market valuations.

Perhaps the most compelling argument for a new bull market in stocks is that real interest rates are now negative, as they last were in 2003. Real rates are simply short-term interest rates on savings, as determined by the Fed Funds rate (currently 2%), minus the rate of inflation (currently 5.6%). Consumers and corporations are now losing purchasing power on the record amounts of cash sitting in deposit accounts and on balance sheets. When real rates turned negative in 2003, after Alan Greenspan lowered short-term interest rates to 1%, we saw an explosive move in stocks, commodities and housing. We see a similar situ-

ation today, with the exception being that investment options are far more limited. Negative real interest rates drive consumer spending on goods and services and corporate spending on inventory and expansion, both of which lead to economic growth. They also lead to investment in assets other than cash, with the stock market positioned as the most attractive alternative for today's record amount of liquidity.

Yet there is a stark contrast between the environment in 2003 and today. Five years ago economic growth in developing countries was accelerating, leading both gold and oil to break out of multi-year bases, at \$300/ounce and \$20/barrel respectively, which gave birth to the bull market in commodities. This established the foundation for energy, industrial and material sector leadership in the stock market up until recently. It was as counterintuitive to invest in these sectors of the market back in 2003 as it is to invest in the financial, consumer and technology sectors today, but that is exactly where we see sector leadership moving forward.

We believe a new bull market is at hand. As global growth slows and commodity prices decline, the rate of inflation will fall. Today's negative real interest rate environment sets the stage for an improvement in leading economic indicators that will diminish recession fears and result in continued strength in the U.S. dollar. Despite a very slow global growth environment, we believe the U.S. will emerge as the best performing stock market around the world. This inflection point will be marked by a change in leadership from the energy, industrial and material sectors to the financial, technology and consumer discretionary sectors. ■

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