



Market Outlook

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A powerful and synchronized upturn in the global economy is underway. While the bears have been convinced for months that a significant decline lurks just around the corner, the bulls remain in complete control of this market. The Dow Jones Industrials (+3.5%), Standard & Poor's 500 (+3.6%) and Nasdaq Composite (+1.5%) all finished the month of August with impressive gains. Financials led sector performance with a gain of 12.8%, while telecommunications was the worst performing sector, posting a loss of 2.4% (source: Bloomberg.com).

At the beginning of the year we built our case for an economic recovery unfolding during the summer months, led by a dramatic rise in stock and bonds prices (with the exception of Treasuries), on the expectation that financial markets would look beyond the recession and toward recovery. This outlook was considered highly improbable at the time by most on Wall Street. At the end of March we staked claim to the idea that a new bull market in stocks was underway--a notion considered equally implausible by most investors. Our assertion in May that the financial sector would lead the rally through the remainder of the year was easily the most unbelievable of our predictions based on the media reports about bank nationalization then prevalent. These views were not brave attempts to throw a Hail Mary pass deep into the end zone, but conclusions we believed were logical, based on the facts presented to us. Our main objective has always been to interpret the economic data and filter the news flow without bias in an effort to explain to our readers how things really are, as opposed to how we

would like them to be. Using this same methodology today, we believe the economy will continue to improve and we are finding more reasons to be optimistic about the financial markets.

The bullish camp is no longer the ghost town that it was earlier in the year. Most investors will acknowledge that the recession many feared was a depression now appears to be ending, and the stock market has rallied more than 50% from the March lows, led by the financial sector. As

corporate earnings reports and data measuring the health of the economy have beat expectations, leading economists and influential market strategists have been forced to raise their estimates. This is not to say that investor sentiment, a contrarian indicator, is overly optimistic by any measure. The state of panic most felt at the beginning of the year has abated, but the cash held in money market funds earning next to nothing still approximates 40% of the value of Standard & Poor's 500.

The bears argue that the 50% surge in the stock market is "irrational exuberance." They claim that the improvement in the economy is temporary and stimulus-induced. When the stimulus fades the economy will slip back into recession.

They believe that the surge in corporate profits is a result of nothing more than cost cutting and that we are unlikely to see revenue growth in the year ahead. They see tepid consumer spending and a rise in the savings rate as significant drags on economic growth with no offset. Home prices will continue to decline, loan losses will continue to mount and the unemployment rate will continue to rise.

We believe that when investors see a resumption of economic growth that exceeds consensus estimates, accompanied by the continued improvement in employment data, sentiment will shift from skeptical to optimistic, and the trillions in cash now earning negligible returns in money market funds will move into the stock market

The problem with this line of thinking is that there is nothing to support it given the economic data we have seen in recent months. Instead, we believe the negative sentiment on Wall Street is an expression of the overwhelming disdain the investor class has for the populist policies of the Obama administration. Yet it is a huge mistake to base an investment strategy on the hope that it will validate a particular political view. We must simply play the hand we are dealt.

The 50% rise in stock prices is truly historic, but so was last year's decline. We view the market as being down more than 20% over the past 12 months and just returning to levels first reached more than a decade ago. We believe the economic recovery to date is more attributable to an improvement in business confidence and the inventory rebuilding that results from a normalization of the business cycle than to the economic stimulus. The bulk of the \$274 billion in infrastructure spending included in the stimulus plan has yet to be distributed. It is perfectly normal to see the initial rise in corporate profits result from cost cutting as we embark on a recovery. What is not normal is to see a rise in profits during the first half of this year that set a record for a recessionary period. This bodes very well for employment gains in the months ahead. We acknowledge that the consumer will be a drag on growth, but this negative is balanced by the benefits we are realizing from the steady improvement in our trade deficit.

We do believe this new bull market is at an inflection point, but not one that will bring comfort to the bears. Stocks began to recover in March at the same time that economic indicators which historically lead a recovery in economic growth began to turn up. These indicators are collectively known as the Leading Economic Index (LEI). Some of the components of this index that we have discussed in recent months include weekly unemployment claims, the money supply, consumer confidence and new orders from pur-

chasing managers (PMI). The sequential improvement in this index since March has led to its first year-over-year increase, which historically coincides with the end of recessions. This now sets the stage for an improvement in coincident indicators of economic growth--an improvement that we believe will lead to a significant turn in investor sentiment and a new leg up in this bull market.

Industrial production is likely to soar over the coming months in an effort to rebuild the unprecedented decline in inventories that followed the credit crisis. We believe the economy will grow north of 4% through the end of this year and well into 2010. As a result, the improvement in employment numbers is also likely to be more robust than the consensus expects. The trends in layoff announcements and unemployment claims continue to improve. The stabilization in home prices and increase in new home starts should lead to an increase in construction employment. The recovery in stocks and bonds should lead to an increase in employment in the financial sector. As for the \$274 billion in infrastructure spending included in the stimulus plan, less than a third of the proposed projects are funded and only a fraction are underway. Regardless, a significant number of jobs will be created as a result.

We are not deaf to the long-term headwinds that face our economy and we are not attempting to spin the data available to achieve a desired outcome. We are simply focusing on what matters most to the financial markets. We believe that when investors see a resumption of economic growth that exceeds consensus estimates, accompanied by the continued improvement in employment data, sentiment will shift from skeptical to optimistic, and the trillions in cash now earning negligible returns in money market funds will move into the stock market. Our initial target in this next leg up in the bull market is 1200 for the S&P 500. A correction of 5-10% from current levels will not sway our outlook, since we believe it will be met with aggressive buying by those that missed this initial rally off the March lows. ■

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