



Market Outlook

LAWRENCE FULLER

Managing Director and Portfolio Manager

The stock market (S&P 500) tested the lower end of the trading range we identified last month (1050-1150) as a downward revision to second-quarter economic growth, along with disappointing numbers on housing and employment, weighed on investor sentiment. The Dow Jones Industrial (-4.3%), Standard & Poor's 500 (-4.5%) and Nasdaq Composite (-6.2%) all finished with heavy losses. Telecommunications led sector performance with a gain of 2.3%, while financials were the worst performing sector, posting a loss of 7.9% (source: Bloomberg.com).

Stocks are inexpensive at current levels, presenting tremendous upside potential over the long term, while bonds are wildly overvalued, posing significant interest rate risk over the near as well as long term from our perspective. Yet fund flows in recent months show investors continue to sell stock funds and purchase bond funds, as they have since the bull market began, in what appears to be one of the most staggering episodes of risk aversion turned performance chasing on record. This is insanity in our view and clearly not the type of investment activity consistent with a looming bear market; to the contrary, just the opposite. The dividend yield of the Dow Jones Industrial Average is greater than the yield on the 10-year Treasury. The last time this occurred was in the midst of the financial crisis, just before the historic advance in stock prices from the bear market lows. We are not predicting a repeat performance, but we

do think that we are in the early stages of this bull market and that bond fund investors face a rude awakening when interest rates rise and fund flows reverse course.

The consensus has clearly bought into an outlook that either we are headed for a double-dip recession or that our economy will grow at stall-speed for years to come, while the rate of inflation endlessly channels between zero and 1%. There are even rumblings that we may be facing a Japan-style era of deflation reminiscent of the deflationary warning espoused by Alan Greenspan in 2003. In our view, these scenarios can't be substantiated by the economic fundamentals. Investors need to factor in the politically driven hyperbole that is fostering these views in advance of the mid-term election before they follow the herd.

Corporate America is boycotting the Obama administration, and perhaps even the economic recovery. Business leaders are opposed to many of the new reforms and regulations, the increase in the size of government that accompanies them, as well as the possibility of higher tax rates in 2011. Some begrudge the administration for vilifying them in the wake of the financial crisis. They have expressed an understandable hesitation to hire and expand without knowing the potential impact of the administration's policy initiatives. This has damaged business confidence. At the same time, we speculate that the political environment has become so hostile that many business leaders don't want to contribute to the

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recovery in the near term in any way that may improve the economic and financial market report card for this administration and the congressional incumbents that support it.

For these reasons, we feel that the mid-term election will be a significant catalyst for stock market performance if the results are consistent with where current polling now stands. The polls indicate that we will have a divided government at year-end similar to the one we had in 1994. A divided government would undoubtedly improve business confidence, as much of the uncertainty surrounding the impact of Obama's policies would be lifted. An improvement in business confidence should lead to an acceleration of job growth, which in turn would result in an improvement in consumer and investor sentiment.

Sentiment is nothing more than a reflection of today's market valuations and the absolute numbers we see day-to-day that measure economic health. The economy grew at an annualized rate of 1.6% last quarter and the unemployment rate is 9.5%. These numbers are dismal when taken at face value, but it is the direction of these numbers over the long term and the rate of change in the numbers that determine future market performance. We believe both will continue to move in a positive direction.

Economic growth was revised down to 1.6% for the second quarter from a prior estimate of 2.4%, but the reason for the revision should not be cause for discouragement. Both consumer spending and business investment were revised upward, but not enough to offset an even larger surge in imports than originally calculated, which led to the lower figure. This revision indicates that the domestic economy

was stronger than previously thought—not weaker.

The headline number on unemployment is equally as depressing when taken at face value, but unless this rate is going to climb from 9.5% to 10, 11, even 12%, it should be viewed positively. The gradual improvement we anticipate for the duration of this expansion is in front rather than behind us, and market prices do not yet reflect this improvement. Our confidence in better numbers comes from the fact that layoff announcements are near a ten-year low, temporary employment is approaching levels not seen since the peak of the prior expansion and permanent employment surveys continue to improve. The number of hours worked per week also continues to climb. These trends are not consistent with an economic recession.

Despite high levels of unemployment, consumer spending has increased in five of the last six months at the same time the savings rate has climbed to 6%. There was a sequential decline in the number of homeowners that fell delinquent on their mortgages in the second quarter. Consumers reduced the amount owed on their credit cards to the lowest level in eight years. The delinquency rate fell below 1% for the first time since 2007. These are characteristics of an improving economic landscape.

Yet investor sentiment has fallen to levels we have not seen since the financial crisis. We view this negative sentiment as nothing more than an opportunity for new investments and upside in stock prices. Those who are waiting for clarity will be run over by reality as we move forward. We still expect the S&P 500 to challenge the April highs before the end of the year and our fair value estimate for this benchmark remains 1350. ■

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