MISSOURI VALLEY PARTNERS

M A R K E T O U T L O O K

Economic Climate

Full-fledged Recession Underway

Third-quarter 2008 real GDP fell at a 0.5% annual rate, the weakest performance in seven years. Real consumer spending fell 3.8% (the biggest drop in 28 years), with the residential construction component of GDP continuing its string of very weak performance. On the positive side, net exports and government spending were strong in the quarter.

Continued deterioration in the economy suggests that annualized real GDP in the just-ended fourth quarter declined by 6% or more, representing the sharpest quarterly drop since the 1980-1982 recessionary period.

CONSUMER TRENDS

U.S. retail sales posted the weakest holiday selling season in 40 years, as consumers cut back on spending late last year amid the deepening recession.

The Conference Board's index of consumer confidence posted an unexpected decline in December to a new all-time low of 38.0. The decline was driven by consumers' pessimistic assessment of their current situation.

After plunging to a near-record low of 55.3 in November of last year, consumer sentiment – as measured by The Reuters/University of Michigan Surveys of Consumers – rose in December to 60.1, the highest level since last September and better than expected. The improvement in consumer attitudes was prompted by the recent sharp decline in gasoline prices, discounts at retail stores and falling inflation expectations.

BUSINESS TRENDS

The Federal Reserve Board's index of industrial production has continued its weak performance, declining 0.6% in November of last year. This marks eight months of declining production during 2008, and another decline seems likely in December.

The Institute for Supply Management's monthly index of manufacturing fell to 32.4% in December of last year from November's 36.2% reading. This was a much larger drop than economists were forecasting, and represents the lowest reading since June of 1980.

The Conference Board's leading index of economic activity fell 0.4% in November after a revised 0.9% decline in October. Weakness in stock prices, building permits and unemployment claims contributed to the decline.

GOVERNMENT TRENDS

The potential for a second economic stimulus package (possibly approaching $1 trillion in spending over the next two years) is now being discussed by President-elect Obama's economic team, an idea earlier endorsed by Federal Reserve Chairman Ben Bernanke. The new legislation, which will likely be signed into law within the next month or so, could include spending on infrastructure (roads/bridges/dams and work on schools, sewer systems, mass transit, electric grids, and other public utilities); "green" spending (wind, solar, biofuels, etc.); assistance to cash-strapped states; food aid for low-income families; expanded benefits for unemployed workers; and tax breaks for consumers and corporations.

Financial Climate

Stocks Plummet, Stage a Rebound

STOCKS

The fourth quarter of 2008 began with eight straight daily declines in stock prices as investor concerns over the global financial crisis reached panic levels. The week ending October 10th was the U.S. equity market's worst weekly decline ever, point-wise and percentage-wise: For example, the Dow Jones Industrial Average fell 1874 points in the week, a decline of 18.2%. But over the following few days, world governments announced coordinated actions to pump hundreds of billions of dollars into their ailing banking systems, touching off a substantial rally in global stock markets.

As a result, on October 13th the Dow Industrials and the S&P 500 posted their best one-day point gain on record, and each rose more than 11% for the day. But heightened worries over a spreading global recession drove the Dow down 733 points on October 15th, or 7.9%, the largest percentage decline since the crash of October 1987. Then on October 28th, the Dow surged nearly 11% as optimism grew that the U.S. Federal Reserve and other central banks would cut interest rates further. On November 21st, the Dow rose 500 points on news of President-elect Obama's appointment of Tim Geithner, president of the Federal Reserve Bank of New York, as U.S. Treasury Secretary. Despite ongoing bleak economic news, stocks generally continued to rally strongly over the balance of the year.

For the fourth quarter as a whole, the Dow Jones Industrials fell 19.1%, the S&P 500 declined 22.6% and the NASDAQ dropped 24.6%. The best-performing sectors of the market in the quarter were telecomm, utilities and health care, while the worst-performing sectors included financials, materials and information technology.

BONDS

Investors rushed to the safety of treasury securities as a safe haven during the financial storm of 2008. In fact, investors were so desperate for safety that the yield on short treasury bill rates was briefly negative. The 10-year treasury ended the fourth quarter yielding 2.21%, sharply below the third-quarter's ending yield of 3.84%. The 3-month treasury bill's yield closed at 0.08%, versus 0.91% at the end of the third quarter.

MONETARY

Largely due to a sizeable drop in energy prices, the Consumer Price Index fell 1.7% in November of last year, a greater decline than expected, while the core CPI (excluding the volatile food and energy components) was virtually unchanged. As of November, the year-over-year price change for the CPI stood at 1.1%, while the core CPI had risen only 2.0%.

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OUTLOOK

Key Economic Indicators	2007Act.	2008Est.	2009Est.
	------Year/Year % Change------		
Real GDP	+2.0%	+1.0%	-2.5%
Corporate Profits (S&P 500)	-2.0%	-20.0%	-10.0%
Real Consumer Spending	+2.8%	+0.4%	-2.0%
Real Business Spending	+4.9%	+2.0%	-9.0%
Consumer Price Index	+2.9%	+4.0%	+0.0%
	----------Million Units-----------		
Auto & Light Truck Sales	16.4	13.2	11.5
Housing Starts	1.34	0.91	0.60
	----------Year-end Level---------		
Unemployment Rate	5.0%	6.9%	8.2%
10-year Treasury Bonds	4.03%	2.21%	2.75%
3-month Treasury Bills	3.24%	0.08%	0.35%

ECONOMY

The National Bureau of Economic Research has officially declared that we're in a recession, and that it began in December of 2007. But we won't dwell here on the economic negatives . . . the news headlines these days tell the abysmal story well enough. Rather, we'd like to emphasize that there are many positives emerging in the economic picture which hold out hope that the current year-long recession may be coming to a close later this year. While it will take awhile before signs of improvement become apparent, the seeds of the next economic upturn are now being sown, and we think we'll see the tangible results sometime during the second half of 2009.

Of greatest significance, there are clearly massive and unprecedented fiscal and monetary stimuli being pumped into the world economies. Trillions of dollars are being allocated to easing credit strains and bolstering business activity in the U.S., and substantial sums have also been earmarked for fiscal stimulus in many foreign countries as they similarly attempt to revive their sagging economies. For example, China recently unveiled a two-year, $586 billion economic-stimulus package, representing 16% of China's 2007 GDP.

Additional favorable developments include: 1) Signs that credit markets are slowly beginning to unfreeze, including recent improvements in high-grade and high-yield spreads, 3-month LIBOR, the "TED spread" and other credit-stress indicators; 2) A sharp drawdown of inventories in many sectors of the economy, setting the stage for a new round of ordering and inventory building; 3) Recent rapid growth in the money supply to levels historically associated with the end of recessions; 4) The stimulative effects of the sharply lower interest rates and borrowing costs as of late (see chart on this page); 5) Dramatically lower oil/gas prices, benefitting all consumers of energy (e.g., with gasoline near $1.50/gallon versus $4/gallon last summer, the impact on consumers is equivalent to a tax cut of nearly $400 billion annually); 6) Renewed weakness in the U.S. dollar, indicating a potential strengthening of exports; 7) Lower rates of inflation, thus increasing consumers' real buying power; 8) The recent boom in home-loan refinancing activity, lowering mortgage interest costs and bolstering consumers' future cash flow and purchasing power; 9) Federal Reserve programs to drive down mortgage rates, improving the outlook for home sales and housing starts; and 10) Stock prices (often a predictor of future business conditions) have rallied sharply, with the S&P 500 now up 26% since the market's lows of last November.

Collectively, these developments strongly suggest that the stage is being set for economic recovery. The timing of an upturn is uncertain, but we think there's a 75% chance that business conditions in the U.S. will begin improving noticeably by late this year.

STOCKS

From an equity-investor's standpoint, one of the best things that can be said about last year is that it's now behind us. The 2008 debacle on Wall Street (the worst year for equities in more than 70 years) – and the business downturn on Main Street – has been quite painful for nearly everyone touched by these developments.

But the New Year offers new hope for better times to come. Given the massive stimulus programs and the other positives discussed above, the odds favor improving economic activity in the not-too-distant future, and stocks typically move well in advance of significant changes in business conditions. And considering what appear to be bargains galore among the wreckage left by the past year of stock market carnage, and the fact that there's a tremendous amount of buying power sitting on the sidelines (nearly $9 trillion held in cash, bank deposits and money-market funds), stock prices could be headed for strong performance this year.

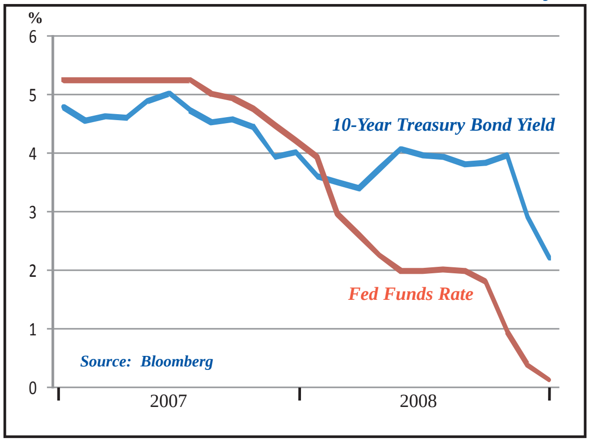
As Dean G. Witter, co-founder of brokerage firm Dean Witter & Co., said in May of 1932 (shortly before the end of the worst bear market in history), "Why not invest now, when securities are cheap? Some people say they want to wait for a clearer view of the future. But when the future is again clear the present bargains will have vanished. In fact, does anyone think that today's prices will prevail once full confidence has been restored? Let us face it – these bargains exist only because of terror and distress. And when the future is assured, the dollar will have long since lost its present buying power."

BONDS

Treasury yields of less than one year are practically zero. The question for bond investors in 2009: Is it time to move out the curve further to increase portfolio yields, or to purchase non-treasury securities to take advantage of even higher yields? The risk premiums for corporate bonds are at very high levels as we begin 2009. These high premiums are justified given the lack of liquidity and the ongoing recession, but there is considerable uncertainty over whether or not the fundamentals will improve during the year.

Our view is that selected high-quality corporate bonds and agency mortgages are attractive. Bonds face a tough 2009, but wide risk premiums give investors reasonable compensation for taking risk. Given the Fed's aggressive policies, treasury rates will likely stay lower than many expect, especially on the short end of the curve. Despite the government's dramatic actions to stimulate the economy, inflation is unlikely to be a problem for the next year or two.

Record Low Yields – A Boost to the Economy?



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