

## Headlines

- GDP contracts 6.3% in fourth quarter 2008.
- S&P 500 has fastest 20% increase since 1937.
- Bond yields stay low with help from the Fed.
- Liquid cash remains at record levels.

	Mar 2009 Return	YTD Return
Dow Jones Industrial Avg	+7.7%	-13.3%
S&P 500	+8.5%	-11.7%
Nasdaq Composite	+10.9%	-3.1%

  

	Qtr End Yield	Year End Yield
10 Year Treasury Yield	2.67%	2.40%
3 Month T Bill Yield	0.21%	0.08%

### GDP contracts 6.3% in fourth quarter 2008.

Real gross domestic product decreased at a rate of 6.3 percent in the fourth quarter of 2008 compared to a 0.5 percent decrease in the third quarter. The decrease in the fourth quarter primarily reflected negative contributions from exports, personal consumption expenditures, equipment and software, and residential fixed investment partly offset by a positive contribution from federal government spending. Imports, which are a subtraction in the calculation of GDP, decreased. Most of the major components contributed to the much larger decrease in GDP in the fourth quarter than in the third. The largest contributors were a downturn in exports and a much larger decrease in equipment and software. The most notable offset was a much larger decrease in imports.

### S&P 500 has fastest 20% increase since 1937.

It's hard to imagine that the S&P 500 was at 1,300 before the collapse of Lehman Brothers, let alone that the failure of this institution and the volatility that followed occurred only a few short months ago. The past six months ending February 2009 were so bad for equity investors; we had to go back to 1932 to find a comparable period of stock returns. We view this period of adjustment as one of extreme pessimism, and perhaps, an overreaction.

Following this correction in prices, the S&P 500 has seen its largest and most rapid increase since 1937. Whether it's merely a bear market rally or something new that is forming, investors are reminded (and relieved) that markets do not go down forever and patience is rewarded. It is in times of

maximum pessimism where opportunity is greatest, though it requires a disciplined investment process to sift through the opportunities.

### Bond yields stay low with help from the Fed.

The Treasury bond market has seen rates fall especially for maturities of less than one year as investors have flocked to safety. Although yields are low, they are not unattractive if your forecast is for a continued decline in equities and real estate. CPI has dropped to near zero making even a 2.7% ten year Treasury an attractive opportunity.

The Federal Reserve is doing all that it can to provide liquidity to the banking system and to keep interest rates low. During March, the Fed began buying Treasuries in an effort to increase the supply of funds to the economy. Several other countries; Britain and Switzerland namely, have recently done the same thing. Japan used a similar strategy for years during the 1990s to battle its economic demons. This policy was not taken lightly by the Fed and indicates that they are committed to keeping interest rates at low levels for the foreseeable future.

### Liquid cash remains at record levels.

The dollar value of cash in non-interest bearing bank accounts, money funds, and short-term government bonds currently stands at a record \$6.0 trillion. This number will continue to climb as long as investors continue to deleverage and view risky assets with skepticism.

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## Outlook

### Economy

The fundamentals of the economy and of corporate earnings have not improved, but we are encouraged by early signs of stabilization and earnings visibility. Stocks will not wait for a full fledged recovery to be underway, but will anticipate the recovery and reprice accordingly. Stocks typically bottom five months before the recession ends, with some of the best returns occurring in the final months of the recession.

### Equities

One of the bright spots in stocks is the early stages of global consolidation. We look for further M&A deal flow to backstop a sustainable recovery. Companies are beginning to see economic value in merging with their competitors and/or acquiring their weaker counterparts. Cash on the sidelines will flow back into risky assets as investors are encouraged by this use of company balance sheets. While the Health Care Sector is leading the way, we think other sectors will soon follow. We expect M&A activity to pick up in 2009/2010 as balance sheets are further utilized and credit markets improve. Notable deals of 2009, so far, are: Merck & Schering Plough; Pfizer & Wyeth; Roche & Genentech; Suncor & PetroCanada; Swiss Re & Berkshire; Abbot & Advanced Medical Optics; CV Therapeutics & Gilead.

Equity valuations are favorable with the 2009 S&P 500 P/E hovering around 14. However, the accuracy of the earnings portion of the metric remain a moving target as corporations have lowered expectations, and in a number of instances, have ceased providing forward guidance altogether. Lowered expectations, whether implied or explicit, could actually benefit markets as reduced expectations matched with easier comparisons could be a set up for positive surprises down the road.

Key Economic Indicators	2007 Actual	2008 Actual	2009 Est
Real GDP	2.0%	1.1%	-3.0%
S&P 500 Earnings (Operating)	-2%	-20%	-10%
Consumer Price Index	2.9%	0.1%	-0.5%
Housing Starts (million)	1.34	0.90	0.50
Auto & Light Truck Sales (mil)	16.4	13.2	10.1
Unemployment Rate	5.0%	6.9%	9.2%
10 Year Treasury Bond	4.03%	2.21%	2.75%
3 Month Treasury Bill	3.24%	0.08%	0.35%

As we enter the second quarter, we note several facts. First, consumers and businesses are moving along predictable lines and repositioned for a recovery. Second, markets are busting the gauge in terms of volatility as evidenced by both extreme bear and bull market returns in the first quarter. Finally, investors are willing to look through the current environment and begin valuing stocks based on something other than the current situation. From the market's standpoint, we see progress being made. Stocks appear cheap, it's been too easy to be negative, and a little good news could go a long way.

### Fixed Income

Although risk premiums are high by historic standards, they reflect a more profound change than just the normal risk aversion of the typical business cycle. The U.S. economy has hit debt levels that are unsustainable and the deleveraging process has begun, forced on our economy by falling asset prices. This process will impair corporate profitability, consumer spending and will also impact the ability of many to repay debt over the next 12-24 months. We are skeptical of the many government plans to support asset prices, because all of the plans use a high degree of leverage to purchase dodgy and hard-to-price assets. Isn't an excess of leverage what caused the problem in the first place? We remain wary of lower quality debt and the securitized debt market. High quality corporate and agency mortgage bonds are priced attractively. Given the prospects for low inflation, medium term Treasury paper is also attractive. Inflation protected Treasury bonds offer inexpensive insurance in the event inflation occurs quicker than anticipated.