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## Headlines

- GDP contracts 5.5% in first quarter 2009
- Green shoots or warnings signals
- Bonds rally as risk appetite returns
- Unemployment continues to rise

	Jun 2009	YTD
	Qtr Rtn	Return
Dow Jones Industrial Avg	+11.0%	-3.7%
S&P 500	+15.2%	+1.8%
Nasdaq Composite	+20.0%	+16.4%
	Qtr End	Year End
	Yield	2008 Yield
10 Year Treasury Yield	3.52%	2.21%
3 Month T Bill Yield	0.18%	0.08%

### GDP contracts 5.5% in first quarter of 2009

Real gross domestic product decreased at an annual rate of 5.5 percent in the first quarter of 2009, compared to the final reading of a 6.3 percent decline in the fourth quarter of 2008. The decrease in real GDP in the first quarter primarily reflected negative contributions from exports, equipment and software, private inventory investment, nonresidential structures, and residential fixed investment. These negatives were partly offset by a positive contribution from personal consumption expenditures (PCE). Imports, which are a subtraction in the calculation of GDP, decreased, which is a good thing in the GDP calculation.

### Green shoots or warning signals

Global equity markets have rallied nicely off the March 9<sup>th</sup> lows creating a powerful trend that has many investors questioning its validity and longevity. This is the proverbial “wall of worry” that professional investors like to see addressed as it typically marks the beginning of new bull markets. We remain long-term optimists for equity investors that are patient and can see through periods of heightened volatility. However, the near-term picture is challenged by: higher savings rates, decreased consumption, waning gross investment, higher unemployment, tighter credit, and continued pressure on the housing industry. These data points must begin to improve for growth to ensue and are fundamental to a lasting recovery.

### Bonds rally as risk appetite returns

The corporate and mortgage bond markets enjoyed a rally during the quarter. As risk tolerances increased investors sold treasury securities to purchase riskier corporate and mortgage bonds. The 10 year treasury yield rose from 2.67% at the end of March to 3.54% at the end of June.

The Federal Reserve purchased agency backed mortgage bonds and Treasury bonds during the quarter to provide more liquidity to the economy and to keep interest rates, especially mortgage rates, low. Indeed the Fed is committed to purchase over \$1 trillion of mortgages and \$300 billion of treasury securities. Meanwhile the Treasury Department is increasing its issuance of Treasury securities to finance the escalating budget deficit. Looking out to the end of 2009 we believe that treasury rates will be influenced by two forces: a slow economy that will push interest rates down and increased issuance that will push rates up. Who will win?

### Unemployment continues to rise

The headline unemployment rate for June 2009 was 9.5%, the highest in over 20 years. More importantly, average hours worked per employee also continues to fall. A very important Green Shoot in the employment arena will be to first have current employees work more hours, which should then be followed by the outright hiring of more employees. A definite Brown Shoot in these employment reports is that the only sector of the economy showing any job growth is the Government sector. Unemployment numbers could get very ugly if State and Local Government hiring slacks off due to budget pressures.

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## Outlook

### Economy

The fundamentals of the economy and of corporate earnings have not improved (yet) across the board and we find solace in the idea that things are getting worse at a decreasing rate. At some point we must see improvement.

The debate rages regarding inflation or deflation and we're reminded of simple supply & demand economics that help illustrate the point. In today's world, the monetary base (supply of money) has been expanded (produced) at a rate not seen in the past 50 years. This process is currently deflationary and will continue to be so until demand for money outstrips supply. Why is there so little demand? There is simply too much leverage in the system from households to businesses to local municipalities to sovereign governments. This is a global phenomenon and a worldwide problem. Until debt is repaid and the savings rate is comfortably higher, deflation (or very low inflation) is likely to continue.

### Equities

Corporations will begin reporting 2<sup>nd</sup> quarter earnings in the coming weeks. These earnings will come under great scrutiny as investors seek clues to whether this current rally has staying power or if a giveback of recent gains is in order. The likely course is the normal sideways consolidation of most summers - light volume and limited conviction.

Last quarter we commented on the relatively favorable valuations on most indices, with the S&P 500 at around 14 times earnings. After the June quarter rally, valuations are not quite as favorable but still somewhat undervalued, provided the earnings component survives the quarter intact or even show some sign of improvement. Valuations still seem to be very reasonable based on more normalized earnings power.

Key Economic Indicators	2007 Actual	2008 Actual	2009 Est
Real GDP	2.0%	1.1%	-3.0%
S&P 500 Earnings (Operating)	-2%	-20%	-15%
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%	9.9%
10 Year Treasury Bond	4.03%	2.21%	3.625%
3 Month Treasury Bill	3.24%	0.08%	0.25%

The components are certainly in place for earnings growth; relatively low inventory levels, continued corporate focus on operating efficiencies, early signs of increased raw material demand and lower energy prices. We are seeing the signals of a slower rate of deterioration in some economic variables, and even improvements in others, though a lower level in the aggregate growth rate for both companies and countries may require further time to be digested than is currently "priced in" to securities.

### Fixed Income

We enter the second half of 2009 very differently from where we entered it. Risk premiums have contracted sharply. Borrowing rates for corporations have declined from late 2008 and early 2009 despite the rise in treasury yields. The corporate bond market has reopened after being shut down for the past six months which has helped market sentiment. Despite all the good news in the credit markets we see a potential for trouble. While nominal borrowing costs have fallen, real costs (nominal costs less inflation) have remained elevated after last year's financial crisis.

Last June the average rate for a corporate borrower was a little over 6%. Inflation last June was around 5% (year-over-year), meaning companies were borrowing at 1% real rates. In October the real rate had jumped to 8%, with inflation falling and yields increasing. By June 2009 borrowing rates had fallen by over 3% but inflation continues to fall, with CPI negative 1.3%. This means that the real cost of corporate borrowing is only slightly below the level seen in the dark days of last fall's credit crisis.

Missouri Valley Partners, Inc.  
135 North Meramec  
Suite 500  
Saint Louis, MO  
63105  
(314) 889-1000  
(Saint Louis)  
  
(845) 920-8112  
(North East)