

## Headlines

- GDP contracts 0.7% in second quarter 2009
- Economic recovery or head fake?
- Déjà vu all over again for bond markets
- No improvement in unemployment rate

	Sep 2009 Qtr Rtn	YTD Return
Dow Jones Industrial Avg	+15.0%	+10.7%
S&P 500	+15.0%	+17.0%
Nasdaq Composite	+15.7%	+34.6%

  

	Qtr End Yield	Year End 2008 Yield
10 Year Treasury Yield	3.23%	2.21%
3 Month T Bill Yield	0.09%	0.08%

### GDP contracts 0.7% in second quarter of 2009

According to the U.S. Bureau of Economic Analysis, real gross domestic product decreased at an annual rate of 0.7 percent in the second quarter of 2009. In the first quarter, real GDP decreased 6.4 percent. The decrease in real GDP in the second quarter primarily reflected negative contributions from inventory investment, fixed investment of all types, personal consumption and exports. Positive contributions to GDP came from federal, state and local government spending. Imports, which are a subtraction in the calculation of GDP, decreased.

The much smaller decrease in real GDP in the second quarter as compared to the first quarter were primarily more spending on fixed investment, more exports, more federal government spending, and a modest increase in state and local government spending. We note that most of these increases in expenditures by the federal, state, and local governments in the second quarter as compared to the first quarter are attributable to the federal stimulus legislation.

### Economic recovery or head fake?

The equity markets performed well in the second quarter, with many commentators suggesting that we have turned the corner, or at least bottomed out economically. Last quarter we wondered if the rally was “for real” and attributed this debate to the classic “wall of worry” that all professional investors address throughout their career. As the old saying goes, one data point doesn’t make a trend, but two data points begin to define one.

### Déjà vu all over again for bond markets

In the bond market it is déjà vu all over again as the third quarter was much like the second quarter. Risk premiums dropped sharply as investors embraced credit risk, just like they did in the second quarter. The ten year treasury joined the party dropping in yield from 3.54% during the second quarter to 3.31% during the third quarter.

The Federal Reserve continued purchasing agency backed mortgage bonds, Treasuries and FNMA/FHLMC issued debt. The Fed will finish its Treasury purchases in October, and announced that it will slow the pace of mortgage bond purchases. In total the Fed committed to purchase \$300 billion of Treasuries and \$1.25 trillion of mortgages. Through these purchases and support for FNMA/FHLMC the government will effectively fund the majority of newly originated mortgages in the U.S.

### No improvement in unemployment rate

The headline unemployment rate for September 2009 was 9.8%, higher than the 9.5% that was reported in the June quarter, and the highest reported number since 1983. Average hours worked per employee has at least stopped falling and begun to stabilize. A very important metric 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. As in prior quarters, 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 debate continues to rage regarding inflation or deflation. Both camps have made eloquent arguments both for and against their case. Statistically, one can look at the glass as both half full and half empty. Prices rose 0.4% in the month of September (giving solace to those in the inflation camp), but prices are still down 1.5% year-over-year (giving ammunition to the deflation crowd).

Another debate occurring in the investment community is over economic growth. The warring parties in this battle are of the camp that we will have anemic growth for quite some time (sub 1% GDP growth), versus the camp that sees sharp growth over the next two quarters (over 3% GDP growth in each), then settling in to slightly below normal 1.8% to 2.2% annualized GDP growth.

### Equities

Corporations will begin reporting third quarter financial results in the coming weeks. These results will come under intense scrutiny (as did those of the second quarter) with analysts looking for improved revenue growth, not just earnings growth. For the third quarter, S&P 500 earnings are expected to come in at \$14.47 a share, a slight increase from the \$13.81 in the second quarter, but still down versus the \$15.96 reported in the third quarter of 2008. The comparables turn very favorable in the fourth quarter of 2009, when the current estimate of \$15.67 of earnings will be compared to the fourth quarter of 2008's loss of \$0.09 per share.

We are still in the camp of economic recovery with bumps along the way, but directionally up. We are intrigued with the idea that everyone (at least the consensus) is still looking for a correction and that the recovery will be a slow slog. We believe the "surprise" will come in the

Key Economic Indicators	2007 Actual	2008 Actual	2009 Est
Real GDP	2.0%	1.1%	-2.0%
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%	10.5%
10 Year Treasury Bond	4.03%	2.21%	3.25%
3 Month Treasury Bill	3.24%	0.08%	0.10%

idea that the recovery could be "V" shaped and therefore move the equity markets higher if it comes to pass. We are reminded of the age old saying that markets always do what they are supposed to do, just not when you think they should do them.

We look at valuation based on more normalized earnings level of \$75 per share for the S&P 500 and multiples look to be fair and certainly not extended. The consensus earnings have been slowly moving towards our more normalized view of \$75 and estimates are now above \$70 for 2010. We think that "high quality" stocks are looking better to us in terms of relative price and therefore lower risk.

### Fixed Income

The corporate bond market continues its winning year as we enter the fourth quarter. Investors continue to embrace risk as the economic downturn has leveled off, but is not yet improving.

Despite the lack of improvement in the economic backdrop, the outlook for corporate credit in general is good. Companies are focusing on managing balance sheet risk and paying down debt. This "derisking", while problematic for economic growth, is good for individual credits. We continue to favor high quality corporate bonds as well as mortgages. Improved liquidity via Government purchases as well as increasing investor interest in fixed income bodes well for continued good results for fixed income for the remainder of 2009 and beyond.