

Headlines

- GDP grows 2.2% in third quarter 2009
- Equity markets deliver a pretty good year
- The Fed, The Fed, The Fed
- Modest improvement in unemployment rate

	Dec 2009 Qtr Rtn	2009 Return
Dow Jones Industrial Avg	+7.4%	+18.8%
S&P 500	+5.5%	+23.4%
Nasdaq Composite	+6.9%	+43.9%
	Year End 2009 Yield	Year End 2008 Yield
10 Year Treasury Yield	3.83%	2.21%
3 Month T Bill Yield	0.06%	0.08%

GDP grows 2.2% in third quarter of 2009

According to the U.S. Bureau of Economic Analysis, real gross domestic product increased at an annual rate of 2.2 percent in the third quarter of 2009. The increase primarily reflected positive contributions from consumers, exports, imports, inventory increases and increased spending by the Federal Government. The only major area weighing on GDP in the third quarter was non-residential construction.

Of the 2.2% growth in the quarter, motor vehicle sales accounted for 1.45% of the overall growth, residential investments accounted for almost 0.5%, and increased government spending accounted for another 0.5%. Absent sectors that were directly supported by Government stimulus programs, the economy did not grow in the third quarter.

Equity markets deliver a pretty good year

The equity markets around the world closed out 2009 on a high note. In the United States, the Dow Jones Industrial Average gained 19%, the S&P 500 gained over 23%, the technology heavy NASDAQ Composite gained 44%, and small caps gained 24%. Internationally, developed markets were up 23% (in line with the United States) but the best performing geography in 2009 was emerging markets, up 66%.

The Fed, The Fed, The Fed

A review of the bond market in 2009 starts and stops at the same place; the Federal Reserve. That's because the Fed purchased over \$1 Trillion dollars of bonds in 2009 and lent billions against illiquid collateral. Total issuance of U.S. dollar denominated debt, net of maturities, was \$1.75 Trillion. In 2009 there was only \$200 Billion of net issuance after Fed purchases.

Because of the Fed's activity, credit spreads came in sharply starting in March. Mortgage spreads also contracted sharply as the Fed purchased more agency mortgage debt than was issued. Despite the Fed's Treasury purchases interest rates rose on Treasury bonds. Owing to miniscule yields, investors sold risk-free Treasuries in favor of other, more risky bonds. Issuance of Treasuries increased as the budget deficit escalated, also putting upward pressure on interest rates.

Modest improvement in unemployment rate

The headline unemployment rate for December 2009 was 10%, unchanged from November but still elevated from the 9.8% recorded in September 2009. Average hours worked per employee has stopped falling and begun to stabilize. The hiring of temporary workers across many industry segments continues to accelerate. Like last quarter, the only sectors of the economy showing any job growth are Health Care and Government.

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Outlook

Economy

Statistically, the economy grew in the third quarter, but most analysts have acknowledged the tepid nature of that growth. Fourth quarter growth is shaping up to be far better than the third quarter's as the long awaited inventory restocking appears to be happening. Even the most stubborn and late breaking economic statistic, unemployment, is getting better and the fact that the hiring of part-time workers is happening at the same time as an increase in hours worked is very encouraging.

At this point in the recovery inflation is non-existent. There has been an ever so slight increase in the year-over-year change in the Consumer Price Index the last few months but even with this increase the resulting single point CPI reading is still well below historical norms.

Equities

Corporations will begin reporting fourth quarter financial results in the coming weeks. The stock market has been responding favorably to recent results, which for the first time in many quarters finally includes an inkling of some positive revenue growth. Recall that this was the blight on the earnings report of the second and third quarters. The comparables turn very favorable in the fourth quarter of 2009, when the current estimate of \$16.75 of earnings will be compared to the fourth quarter of 2008's reported loss of \$0.09 per share.

We are firmly in the camp of economic recovery with bumps along the way. We are also intrigued with the idea that the consensus thinking is calling for a near-term correction and that the recovery will be a slow slog. Therefore, we believe the "surprise" could come in the form of a sharper recovery leading to a higher stock market.

Key Economic Indicators	2008 Actual	2009 Act/Est	2010 Est
Real GDP	1.1%	-2.0%	2.0%
S&P 500 Earnings (Operating)	-20%	-15%	+30%
Consumer Price Index	0.1%	+1.2%	+1.5%
Housing Starts (million)	0.90	0.55	0.65
Auto & Light Truck Sales (mil)	13.2	10.3	10.8
Unemployment Rate	6.9%	10.1%	9.9%
10 Year Treasury Bond	2.21%	3.83%	3.80%
3 Month Treasury Bill	0.08%	0.06%	0.25%

Valuation still looks reasonable with the S&P 500 trading around 14 to 15 times our 2010 earnings estimate. The consensus earnings estimates have been slowly moving towards our more normalized view of \$75 plus over the last few quarters and is now at \$77 for 2010. We think that "high quality" growth stocks are looking better to us in terms of relative price and therefore lower risk.

Fixed Income

2010 is shaping up to be an interesting year in the bond market. In our review of 2009, we discussed the Federal Reserve buying almost the entire dollar denominated debt issued in 2009. That purchase program is scheduled to end during the first quarter of 2010. Issuance of U.S. dollar denominated debt is expected to increase to \$2.22 Trillion from \$1.75 Trillion issued in 2009. Almost 40% of the marketable Treasury debt matures within one year. The big question for 2010 is can the government continue to increase its borrowing without putting upward pressure on interest rates?

In addition to purchasing Treasuries, the Federal Reserve has been actively buying mortgage securities as well. Many analysts wonder what might happen to mortgage rates if and when the Fed stops buying \$1.5 Trillion of mortgages? The conundrum for bond market participants in short is will there be enough demand for debt to allow the Fed to stop purchasing debt or will it need to continue to purchase debt to keep rates from rising and squashing the budding recovery? Interesting times indeed.

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