

Headlines

- **GDP continues its slow growth pattern**
- **Bounce back quarter in both small and large cap stocks ends seesaw year**
- **Bond market the place to be for the past decade**
- **Unemployment continues its slow improvement to 8.5% in December**

	2011 Return	2010 Return
Dow Jones Industrial Average	8.3%	14.0%
S&P 500	2.1%	15.0%
Russell 2000	-4.2%	26.9%

	4th Qtr End 2011 Yield	Year-End 2010 Yield
10-Year Treasury Yield	1.88%	3.30%
3-Month T-Bill Yield	0.01%	0.14%

GDP Continues Its Slow Growth Pattern

Real Gross Domestic Product has steadily improved during the year from 0.4% in the first quarter, to 1.3% in the second quarter, to 1.8% for the third quarter. It looks as though the economic engine may be gaining momentum. The economy, recovering from the 2008 recession, still remains hindered by a depressed housing market, companies slow to add workers, and budget constraints on state and local government spending.

Bounce Back Quarter in Both Small and Large Cap Stocks Ends Seesaw Year

The S&P 500 was up 6% in the first quarter, flat in the second quarter, down 14% in the third, and up 12% in the fourth quarter. The net effect was +2% for the year, or basically, the dividends earned. The Russell 2000, the Small Cap Index, followed a similar seesaw year, finishing -4% for the year, not having the dividends to help out. Large cap dividend-paying stocks led the way.

Bond Market the Place to Be for the Past Decade

Compare the S&P 500 return to the Barclays Aggregate Bond Index for the past five, seven, and ten years, and you will find an anomaly. Bonds have outperformed stocks for all these periods. This is contrary to the longer-term history, but for the past decade bonds have been the winner. For the year, the Barclays Aggregate was 7.8% and the Barclays Interm. G/C +5.8%. Even the August 2011 downgrade of U.S. debt could not stop this trend.

Unemployment Continues Its Slow Improvement to 8.5% in December

The unemployment picture seems to be steadily improving. The January 2011 rate was 9.1%, and ever so slowly that rate has dropped to the 8.5% estimate for December. This trend is encouraging and must continue for the economic recovery to really take hold. Corporations have been slow to add workers even though corporate profits have increased, resulting in slower consumer income growth and spending.

Outlook

Economy

The slow growth camp seems to be gaining vs. those believing we are headed for another recession. Improving trends in the GDP and employment picture would seem to add credence to those economic forecasts. Last year, the DJIA rose or fell more than 2% in one day more than 30 times. This is not very conducive to long-term investment planning. This past year, the market fought through: a Japanese Tsunami, the Arab Spring, U.S. debt downgrade, and almost hourly reports on the European crisis to basically end flat. We continue our mantra, calling for slow growth in 2012.

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Key Economic Indicators	2010 Actual	2011 Actual	2012 Estimate
Real GDP	+2.9%	+1.3%	+1.0%
S&P 500 Earnings (Operating)	+34.0%	+10.0%	+5.0%
Consumer Price Index	+1.5%	+3.5%	+2.5%
Housing Starts (million)	0.59	0.60	0.70
Auto & Light Truck Sales (mil)	11.5	12.7	13.5
Unemployment Rate	9.4%	8.5%	9.0%
10-Year Treasury Bond	3.37%	1.88%	2.10%
3-Month Treasury Bill	0.13%	0.01%	0.01%

Equities

It was actually an outstanding quarter for stocks, with large cap stocks returning 12% and small cap at 15% plus, as represented by the S&P 500 and Russell 2000, respectively. This bounce back was surely needed as the S&P ended the year +2% and the R2000 finished -4% after all the market gyrations. The largest of the large companies paying dividends performed the best for the year, as safety was the word. Looking forward, we continue to like the information technology, and industrial sectors, and have slightly overweighted those positions, while underweighting utilities and telecommunication.

Fixed Income

Interest rates were largely unchanged during the fourth quarter. The ten-year Treasury ended the year below 2%, the thirty-year below 3%. Yields on the front end of the yield curve are still barely above 0%. Indeed, an investor needs to buy a five-year treasury to get a yield above .5%. Treasury rates are being held down by a lackluster economy and a stream of bad news from Europe on their debt crisis.

Looking to the first half of 2012, we see no great change in interest rates. The Federal Reserve will not raise short-term interest rates any time soon because of the tepid economy. The volatility of the world financial system will likely keep investors apprehensive and supportive of Treasury prices for the first half of 2012. In the fall of 2011, we thought that corporate bonds were a good purchase, as credit spreads had widened throughout the summer. Risk premiums did level out during the fourth quarter of 2011, and corporate bonds had good returns for the quarter. We think that this rally is ending, and the corporate bonds will underperform Treasuries during the first half of 2012.

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