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Weaker retail sales and consumer spending points toward weaker growth

## 2007 4<sup>th</sup> Quarter Review

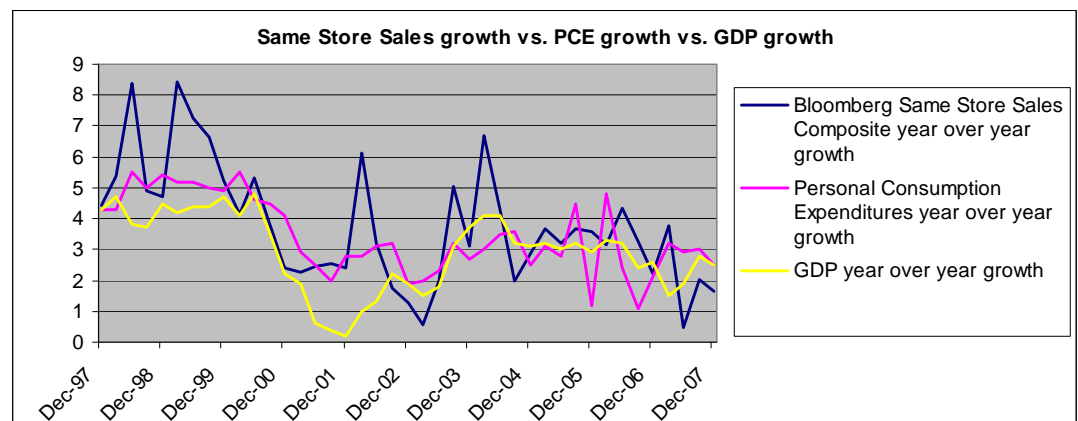
The 4<sup>th</sup> quarter began with the U.S. equity market riding on the coattails of strong 4.9% GDP growth in the 3<sup>rd</sup> quarter. Although financial firms continued to report writedowns, the broader market showed resilience. But by the end of the quarter, deteriorating economic conditions began to appear more prevalent. Weakness began to be noted beyond subprime and the market began to further discount the reality of an economic slowdown and potential recession.

Working to adjust to slower economic growth, the MSAM Growth Composite produced weak results in the 4<sup>th</sup> Quarter. Updated performance numbers are available on the MSAM website: <http://www.msam.net/products.htm>.

We used the 4<sup>th</sup> quarter period to do two primary things: 1) conservatively put money to work in select companies where we identified value to be least impacted by deteriorating economic conditions in the U.S.; 2) raise cash in anticipation of buying opportunities through: A) the elimination of positions where growth prospects and valuation are in question due to the US economic environment; B) the receipt of cash as a result of positions we were taken out of in a merger/acquisition. Our conservative approach in putting new money to work was evidenced by our cash position ending the fourth quarter of around 28% of the Growth Composite portfolio.

## Current Observations

1: The recent downturn in the economy can be at least partially seen in reviewing the trend in consumer spending, and specifically, retail Same Store Sales (SSS). The chart below shows SSS growth which is an input into personal consumption expenditures growth, which is a further input into GDP growth.



Source: Bloomberg

SSS growth was the lowest for a 4<sup>th</sup> quarter since 2002. Not surprisingly, GDP

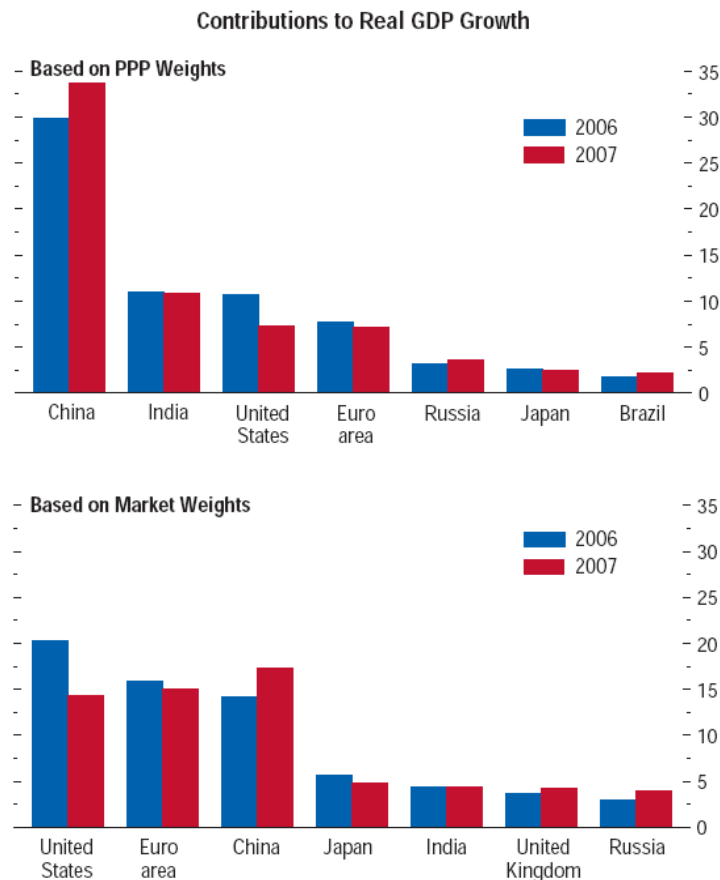
growth confirmed this weakness as it was reported at just 0.6% for Q4 2007, also the lowest for a 4<sup>th</sup> quarter since 2002. While economists continue to debate whether or not a recession is upon us, the material drop in GDP growth in the 4<sup>th</sup> quarter indicates that some of the damage is already done.

2: Although weaker GDP growth is a reality in the U.S., the question of its impact on global growth has been open to debate. The International Monetary Fund (IMF) was set to release its updated world growth estimates on 1/25/08, but postponed the issuance of its forecasts. IMF's Director of external relations indicated they are further revising their estimates since "a number of downside risks we identified when we made our forecasts have materialized." Although downward revisions to IMF's world growth estimates are expected, one item of note in IMF's last economic release, October 2007, was the importance of emerging markets to global growth. As the chart from the IMF below indicates, emerging markets are now the greatest driver of world growth.

### Emerging Markets Now the Major Engine of Global Growth

(Percent of world growth)

IMF data shows emerging markets are the largest contributor to world GDP growth



Source: IMF staff calculations.

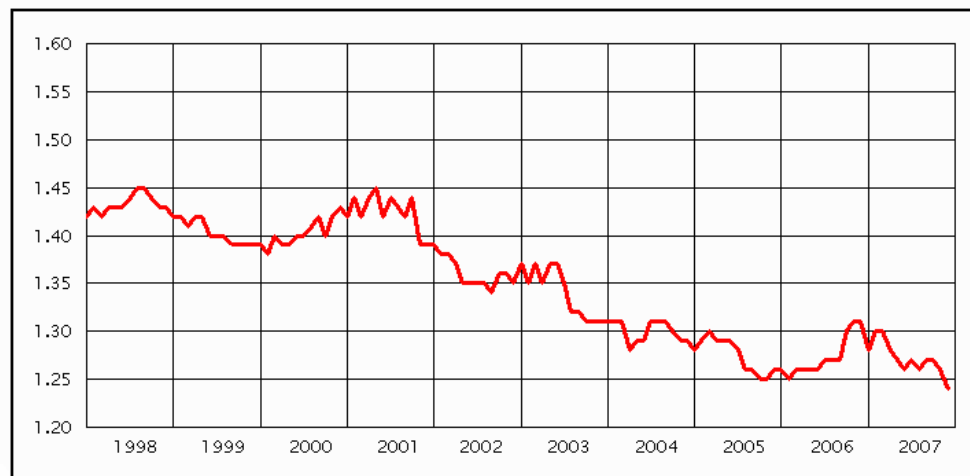
With the U.S. contribution to Real World GDP growth of 7% to 15% depending on the weighting, it would seem that a U.S. consumer pause has a much less significant role in the world growth story. While the above chart offers little consolation to a domestic U.S. firm whose market is U.S. consumer based, it is of potential value to the firm that serves international markets. With the S&P 500 deriving 50% of its

revenue from outside the U.S., there may be the opportunity to have an economic slowdown in the U.S. of lesser magnitude and duration than would be the case without the international growth story.

3. Another recent data item that may point to a U.S. slowdown of lesser duration and magnitude is the Inventory/Sales, or I/S ratio. A known byproduct of any recession is inventory buildup, which results when sales growth slows. Already struggling due to slowed sales, inventory buildup compounds problems for business when the economy has slowed, creating a snowball effect and worsening the downturn. Prior to the 2001 recession, the I/S ratio continuously rose from 1.38 in early 2000 to its peak at 1.45 during 2001. However, the current I/S ratio has been reported at 1.24, a record low.

### Total Business Inventories/Sales Ratios: 1998 to 2007

(Data adjusted for seasonal, holiday and trading-day differences but not for price changes)



Source: U.S. Census Bureau

4: Earnings growth in 2008 is currently forecast to improve materially in the second half of the year for S&P 500 companies as noted in the table below.

| Expected quarterly and annual year over year earnings growth | Q4/07  | Q1/08  | Q2/08  | Q3/08 | 2007   | 2008  |
|--|--------|--------|--------|-------|--------|-------|
| S&P 500 Index  | -16.6% | 3.0%   | 2.2%   | 18.5% | -0.2%  | 15.9% |
| Consumer Discretionary                                       | 4.6%   | 6.0%   | 9.2%   | 38.2% | 2.3%   | 8.5%  |
| Consumer Staples   | 9.2%   | 9.4%   | 8.8%   | 9.9%  | 15.1%  | 10.8% |
| Energy   | 16.7%  | 24.2%  | 5.3%   | 20.0% | 2.1%   | 13.4% |
| Financials   | -94.5% | -18.3% | -18.4% | 34.9% | -25.6% | 28.3% |
| Health Care  | 13.5%  | 4.0%   | 11.4%  | 10.9% | 14.6%  | 10.1% |
| Industrials  | 6.4%   | 8.1%   | 10.4%  | 8.5%  | 8.3%   | 12.4% |
| Information Technology                                       | 24.4%  | 13.4%  | 19.4%  | 15.3% | 11.6%  | 22.2% |
| Materials  | -0.7%  | 11.5%  | 6.4%   | 3.6%  | 13.0%  | 8.3%  |
| Telecommunication  |        |        |        |       |        |       |
| Services   | 30.8%  | 10.7%  | 9.1%   | 10.1% | 27.8%  | 12.0% |
| Utilities  | 15.6%  | 5.6%   | 4.8%   | 5.9%  | 7.1%   | 8.0%  |

Source: Thomson Financial, Bloomberg

The inventory/sales ratio may offer a silver lining

Year over year estimated Earnings Growth % for the S&P 500 reflects resumed growth, especially in the second half of 2008.

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## 2008 1<sup>st</sup> Quarter Preview

Our focus is now turning toward determining the magnitude and duration of the economic slowdown, and to pick our spots for putting money to work. Many statistics, like the I/S ratio noted above, the recent interest rate cuts totaling 1.25% from the Fed, and the economic stimulus package working its way through congress should help lessen the magnitude of the downturn.

While the current environment offers more than enough gloom and doom in reading the financial news, it actually presents an excellent opportunity, with patience, to let the valuation research we do work for our investors. For example, with a broad view, we're looking to get to a point where the slowdown stabilizes and we can begin to "see across the valley" of slower corporate performance. At that point in a slowdown, the broad market will cease to send stock prices lower on bad news. Taking the narrower view, looking at companies where we already know what the long term normal business model is capable of producing, and have valued the firm, we can take advantage of the current environment opportunity to buy that business on the cheap. In other words, we can already "see across the valley" for that individual firm. Since the market is generally reflecting expectations for the next quarter or the next year's earnings, it presents us with an opportunity to contrast near term results with long term performance and let our research work for us.

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