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*Weak Economic Growth but not unlike prior recessions*

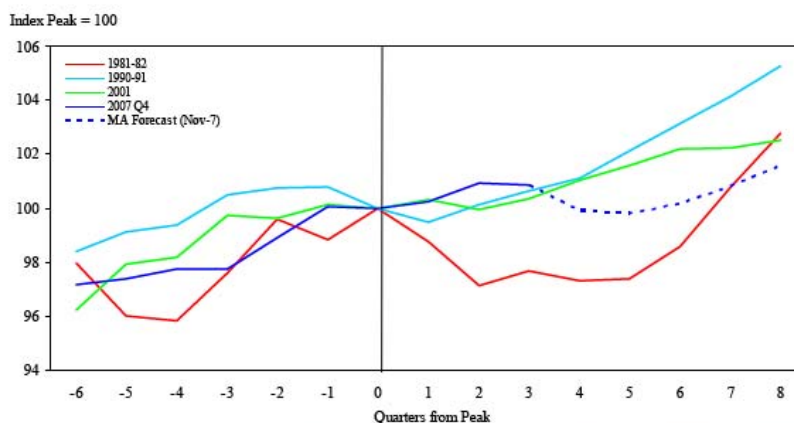
## 2008 4<sup>th</sup> Quarter Review

Lackluster performance in the quarter added to what became the worst annual return for the S&P 500 since 1937. Primary weakness in the financial sector spread to every sector of the market. Leading economic indicators turned down to the worst levels in the last 60 years. The MSAM Growth composite experienced its worst quarterly performance since inception. Updated performance numbers are available on the MSAM website: <http://www.msam.net/products.htm>.

There was nowhere to hide as an investor in stocks in the 4<sup>th</sup> quarter. Although we experienced steep losses in the quarter, steps we had taken previously to address a weakening business cycle helped lessen their scale. We maintained higher cash levels and continued to invest in longer term themes to take advantage of weak market prices.

## Current Observations

A great deal of attention is focused on the magnitude of the economic downturn. Although some have said the current recession is without precedent, the graph below appears to indicate otherwise. It compares the current recession to the



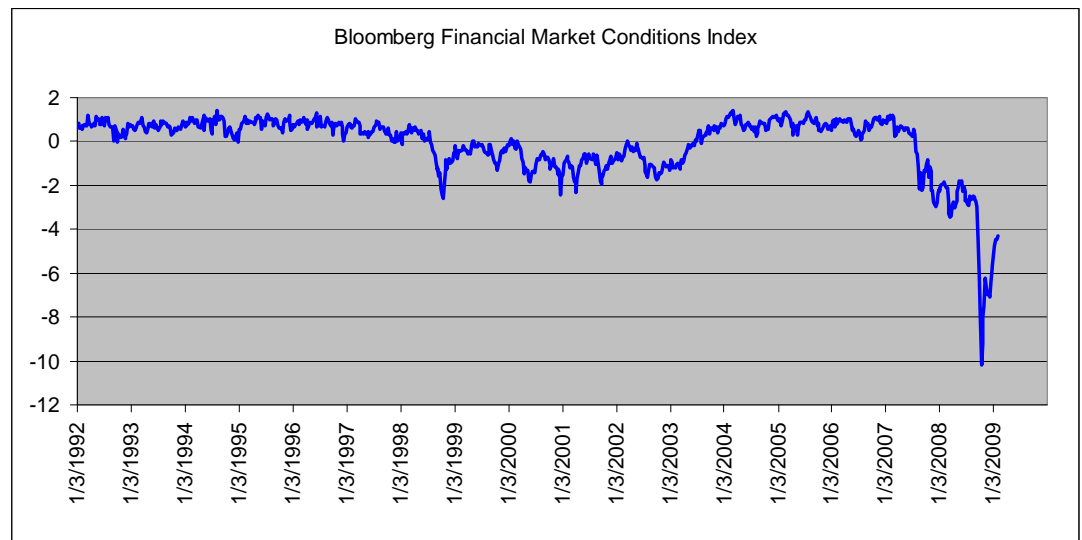
JAMES BULLARD

Source: St. Louis Federal Reserve

*Financial Conditions are improving but still have a way to go*

prior three recessions. Presented by James Bullard, the President of the St. Louis Fed, in early December, it shows that economic activity in this business cycle doesn't look appreciably different than in prior recessions when looking at the relative magnitude of decline, and the length in time from the previous economic peak. With a peak in the 4<sup>th</sup> quarter of 2007, we're now in the fifth quarter from the last peak. The dotted line forecast in the graph, from Macroeconomic Advisors, forecasts a bottom in GDP around five to six quarters after the peak. Bullard commented in his presentation that while economic weakness is clear in the current environment, he also thought a lack of confidence in the market was playing a great role in the weakness.

One place to see the market weakness, and the effect of the lack of confidence that Bullard referred to, is by reviewing a financial conditions index developed by Bloomberg's Michael Rosenberg. This composite index is made up of money market, bond market and equity market components. Zero represents normal market conditions since 1992. This composite bottomed at a value of -10 in October after the Lehman bankruptcy and prior to government intervention to help shore up the banking system. That big drop represented the lack of confidence and the systemic



Source: Bloomberg

risk the Federal Reserve and governments around the world worked to address last fall. Since that time, the money market components have improved. The bond market spreads are narrowing as buyers are returning. And the equity markets are beginning to follow. While the composite still has a way to go to return to normalcy, overall conditions continue to improve.

Turning to housing, where many of the problems the economy is facing began, an index we continue to watch is the existing home sales – months' supply. This index is provided by the National Association of Realtors and covers some 85% of home sales. With home prices that have continued to fall and increased foreclosure sales, the market is beginning to come into balance. The average months' supply of homes since the index began in 1982 is about 7.2 months. The latest reading for December, at 8.7 months has come down to the lowest level since May of 2007.

Real Estate market appears to be coming into balance

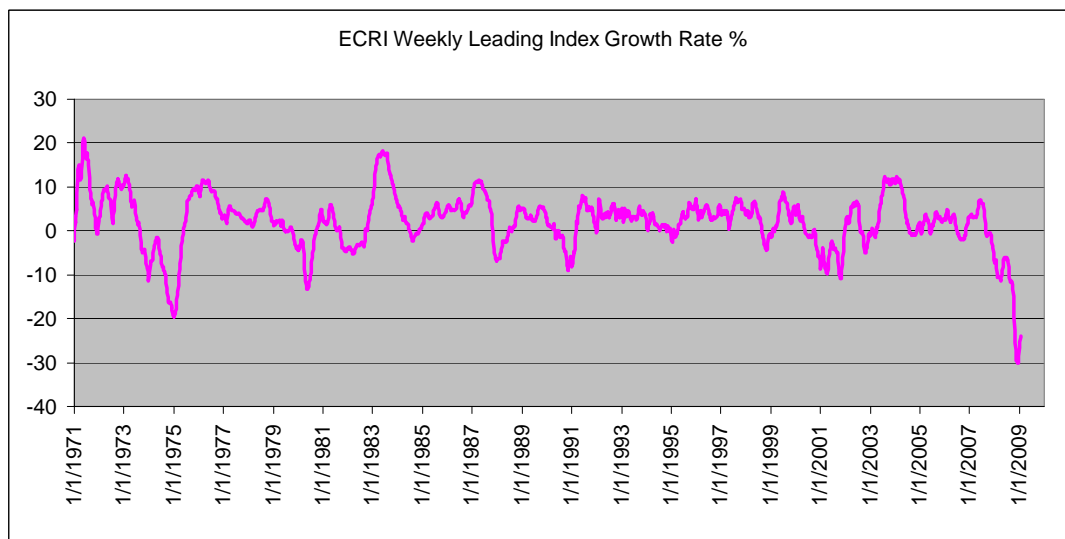


Source: National Association of Realtors, Bloomberg

Continued improvement in this index, along with supportive government policy should be a very welcome event which should lead to stabilization of home prices and a healthier market.

Finally, the growth rate for the Weekly Leading Index from the Economic Cycle Research Institute appears to have bottomed out in December. While there

ECRI Weekly Leading Index appears to have bottomed



Source: Economic Cycle Research Institute, Bloomberg

is a long way to go to return to positive economic growth, the first step is to see the growth rate bottom and start moving in the right direction.

## 2009 1<sup>st</sup> Quarter Preview

The fear and market weakness present in the fourth quarter of 2008 should provide a bottom and base to build from as evidenced in the indicators above. Add a second round of government stimulus, and we should have the beginnings of an economic recovery. But with the damage that's been done, the recovery will take

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some time to materialize. Corporate earnings results will continue to be weak but should stabilize as 2009 progresses. The stock market has likely discounted most of that and should begin to look across the valley of weaker results.

A very important event will be the shift in market sentiment as we return to thinking and talking about stabilization and growth rather than continued weakness. This will be evident by a return to market commentary about corporate results, income statements and economic recovery in general rather than talk of banks, their respective balance sheets, and whether there is enough capital. We expect this shift to happen this quarter. As this shift in sentiment occurs, we will begin to be rewarded for the emotional expense we've endured as investors, over the last quarter in particular.