

First Quarter 2008

It was a brutal quarter. Bear Stearns failed. Write-offs at financial institutions continued unabated, bringing their total to over 200 billion dollars in bad paper. The dollar looked more like the peso than the world's reserve currency. Oil hit \$100 a barrel. It became clear that if we weren't in a recession, it was a good imitation of one. US stocks had their worst performance in fifteen years and foreign markets went from soaring to scary. Real estate prices continued to decline, robbing more than a few pennies from what Americans had thought was their piggy bank. Little wonder consumer confidence is at a ten year low and 81% of Americans think the country is on the wrong track. Who would have thought that 81% of Americans could agree on anything?

Vice President Dick Cheney summed it up with his usual glibness. When he was asked to comment on the current malaise, he looked the offending reporter in the eye and asked... "So?" We got all that bad news and more, but the stock market only dropped about another 10% to complete a 20% correction from its highs last year. Not what we wanted but perfectly understandable given one disaster after another. What is perhaps less understandable is why we were treated to an April treat instead of a trick. During the first four days of trading the market shot up four percent despite UBS announcing their biggest write-off yet and unemployment going over 5%. There must be some people in addition to the VP who think the world isn't coming to an end. What are they thinking?

Bear Stearns failed but the Federal Reserve made it clear that they wouldn't allow a run on big brokers and banks. Financial markets can now trade with confidence, knowing that however bad their portfolios might be, the Fed will not let a major US financial institution renege on its obligations. The one way trade on the falling dollar is probably over. It's been taken to the extreme and is ready to rally. The same can be said for the one way trade in oil. At \$100 we finally saw some weakness in demand which could bring down the price of oil and other commodities. You probably can't have it both ways, either the world economy slows and demand for commodities decreases or there won't be a recession.

Historically, the best returns for the stock market have been preceded by a 20% correction. There is no sense worrying about the stock market now. It's already probably discounted all the bad news and the question now is: when will the recovery come and how strong it will be? There is a ton of cash and treasuries that will go back to US equities as soon as there is any kind of confidence that the worst of the current financial crises has passed.

What will cause the turn in market sentiment is anybody's guess but there are a quite few good things that could happen before year end. My personal favorite is the possibility that we could see a decline in mortgage default rates. I'm not saying house prices will go up. You don't correct a housing market that doubled in five years with a 10% correction. I'm just saying that a lot of the one in 500 houses that are in default are from speculators and flippers who never intended on making more than a few payments. Most of the fast money guys have been washed out. Now we are down to real people who have homes,

not a get rich scheme. Just because your house is worth less than you paid for it, doesn't mean you are going to declare bankruptcy, lose your credit cards, and move into an apartment. That means that there is good chance that a lot fewer people will be walking away from their homes than we have seen over the past year. That will most likely give a bid to the mortgage derivative market and give some certainty to balance sheets of the major brokers and banks.

Of course it's always possible that the banks have actually written off more than they have to. Even if foreclosures increase, it could still be much less of a problem than what is anticipated in the current price of mortgage-backed paper. Reports are coming in of big money buying whole condo projects in Florida and Las Vegas for a lot more than the mortgages have been trading for.

Even if the mortgage crisis stretches out for another year or two, it doesn't mean that our economy has to come to a halt. The damage to US investors in the subprime mess has been relatively small because Wall Street sliced and diced the loans so they could get spread all over the world and kept only what they couldn't sell. It's not pretty to see half a trillion dollars disappear but if somebody has to take the hit its better it be taken by Wall Street and Fleet Street rather than Main Street. Unlike the tech bubble, consumers didn't buy subprime mortgages.

Not that losing twenty or thirty percent of a home's value is going to make people feel great but a house isn't supposed to be an investment. A home is not an economically productive asset. In fact, at the extreme, it's just a form of useless wealth hoarding. Individuals and economies that put money in non-productive assets are poorer for it. Real estate is not supposed to multiply wealth like a factory or a share in a corporation. House prices aren't suppose to double every five years either. Over the last century they have just barely kept up with inflation except for a few extraordinary times. If people have to get hit over the head with the bloody hammer of reality to learn that lesson it's unfortunate but..."So?"

The stock market's twenty percent decline is probably signaling a recession (it's signaled 8 of the last 5). If we have a recession, it will be the first one in modern history that saw the Fed cutting interest rates before it started instead of raising interest rates to cause it. It will be the first one where the government just sent out checks to people to ease their pain, and it will be the first one we entered with nearly full employment. We are throwing a ton of money at this crisis and we are turning the financial system upside down to avoid another shock. We seldom lose the war we are currently fighting; it's the problem we didn't anticipate that usually hurts us.

I'm not trying to be a cheerleader for the economy here but there is a big difference between a financial crisis and an economic crisis. This is still a financial crisis. It's about paper and money. The world's economic growth will probably slow down from a record three years of over 4% growth to closer to 3% but that's plenty of room for US corporations to continue to reap record profits (as long as they make turbines or routers instead of CDOs).

It's always fun speculating on what the market will do but there are only a few things that investors need to know. Prudent investors avoid manias and buy panics. Only a major structural change in markets should alter that dictum. A major structural change would be something like a simultaneous banking, trade and political crisis that caused the great depression or the hideously overvalued market and dysfunctional economic policies that caused the decade long Japanese stag-deflation.

We may be in trouble but we are nowhere near having problems like that. Which leaves us with the one and only appropriate opinion in today's market...buy it!

Just in case you think we have taken too many happy pills, let's talk about the bond market. With few exceptions...we hate it.

Yields are terrible, the risks are high and everybody loves bonds. The market presents little value to us. The short end of the market is controlled by the Fed. Clearly they appear determined to lower short-term interest rates to zero if they have to try to save the economy. Low short-term yields eventually cause investors to do what they know they shouldn't, buy longer term bonds to chase yield. That's fine but pricing the ten-year treasury to yield 3.5% with inflation over 4% is just plain silly.

Yes, municipal bonds are cheap relative to treasuries but relative values are seldom real values. 2-4% tax free is better than 1.5-4% taxable but it still leaves you with a negative real rate of return. For that negative return what do you get? Safety, if you stay with high grade, short term securities, but little else. If you try to buy longer term bonds to improve your yield you are taking a huge risk. The risk is that interest rates will go up and the value of your bonds will go down.

There are dozens of things that could conspire to send interest rates higher. Interest rates could go up if there is an economic recovery, commodity inflation, mandated benefits could cause wage inflation, an increase in corporate taxes, government deficits or just the lessening of the current financial crises. Do any of these things seem possible?

They do to us! So, we think the bond market is expensive with a few exceptions. The high yield and less liquid side of the market is reasonably priced in our opinion (dead cheap compared to treasuries but you know what we think about relative values). We have been buying some lower rated corporate bonds in companies with which we feel comfortable. Spreads are back to decade long highs for high yield bonds. The yields on these bonds are high enough that we think that the bonds should give us a positive return, even if interest rates go up. That's something that can't probably be said for treasury bonds.

We've been able to find a few municipal bonds that are backed by good corporations, some with insurance that nobody trusts anymore so institutions had to sell. We will continue to look for these kinds of bargains in the bond market but we are unenthusiastic buyers.

What we won't do is reach for yield by buying stuff that looks safe but probably isn't, like long-term bonds and preferred stocks. We also think it's too early to call a turn in the real estate market by buying REITs or mortgage backed funds. We like publicly traded oil and gas LPs as much better alternatives to real estate and junior debt.

As we enter the second quarter we look back on more than a tough quarter, it has been nasty for over a year now. At this point a correction begins to wear on investors and the harbingers of doom and gloom are in full form. The easiest thing now would be to capitulate and join the "smart money" in cash, commodities or whatever else was trading up last quarter. Of course, it would be the exact wrong thing to do for investors who need to have a predictable return on their assets, not a return based on speculation and luck. How do we know that investors will be rewarded for their travails? All we can say is that it's always historically worked this way in our investment career that spans some twenty five years and in the historic record before that.

Bear markets are tests of investor's wills and money managers' ability to both perform and give their clients the confidence they need to see it to the other side. We are proud of the fact that our clients are confident in our ability to manage their money through good and bad times. We think that having a consistent philosophy that anticipates both bull and bear markets helps our clients deal with the claims and the storms that the market inevitably serves up.

If you have any questions about your portfolio, our current thinking on the market or just want to say hi, we encourage you to call. We'd love to hear from you.

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