



## **4<sup>th</sup> Quarter Market Commentary**

While most U.S. stock indexes finished 2007 with gains for the year, stocks traded lower in the final quarter of 2007. Continued deterioration in the housing market, concerns over subprime mortgages and crude oil testing \$100 per barrel all undermined investor confidence. The fourth quarter began on a positive note in response to the third-quarter interest rate cuts engineered by the Federal Reserve. The Fed reduced rates by a total of an additional .50% during the fourth quarter. However, as end of the year approached, investors seemed preoccupied with inflationary pressures, lackluster holiday retail sales and news reports detailing the impact of subprime exposure on large financial companies.

The blue-chip Dow Jones Industrial Average gained 6.43% for the year but returned -4.54% for the quarter. The S&P 500 index gained 5.49% for 2007 but sustained a -3.33% setback for the quarter. The technology-sensitive Nasdaq Composite Index rose 9.81% for the year while giving up -1.82% for the quarter. The Russell 2000 Index, a measure of U.S. small-cap stock performance, declined for both the year and the quarter, with returns of -1.56% and -4.57%, respectively. The MSCI EAFE Index, which tracks foreign stocks in developed markets, gained 11.17% for 2007 but fell -1.75% for the quarter. In this environment, foreign shares continued to be supported by a weak U.S. dollar.

In general, larger stocks were the better performers among the market's capitalization groups; but the real story in the fourth quarter was the continued dominance of growth over value. One of the primary reasons for the disparity between growth and value for the year was the poor performance of financial stocks, which typically reside on the value side of most indexes. On the other hand, technology, a growth sector, was one of the year's better performers. Further, given the weak U.S. dollar, investors benefited from the fact that many technology companies derive a significant portion of their revenue from abroad.

Similar to the equity market, the bond market too had distinct pockets of strength and weakness. High quality bonds, particularly US Treasuries performed well amid growing concerns about a slowing economy and even a possible recession in the United States. As might be expected in periods of increasing sensitivity to risk, high-yield bonds were one of the bond market's weakest sectors. The yield of the benchmark 10-year Treasury note fell from more than 4.50% at the beginning of the 4th quarter to just above the 4.00% mark by year's end. The yield curve steepened throughout the year, mostly as a result of the long end of the yield curve not responding to the same degree as shorter maturities.

In retrospect, 2007 was a year in which the subprime mortgage situation developed from a concern into a crisis. In 2008, the Fed may well have to step up its pace and magnitude of interest rate reductions. In addition to the Fed's role, Sovereign Funds have made significant equity investments in a number of large financial institutions. It is

imperative that the financial backbone of our economy is secure and vibrant. While the current stresses are worked through, the fact remains, that it is very difficult to predict recessions. It is also true that stocks can perform well during an economic slowdown. Given the difficulty of timing recessions and their relatively infrequent appearance, we are committed to staying invested for the long term, consistent with one's risk tolerance and time horizon.



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