



## **Market Commentary**

The second quarter of 2008 was another difficult one for the world's markets. The S&P was down 2.9% for the quarter and 12.1% for the first half of 2008. The Dow Jones Industrials fared considerably worse posting a -7.44% return for the quarter due to larger exposure to financials and autos. Along with the equity market, the increasing focus on inflation also had a negative impact on the bond market. The Lehman Brothers U.S. Aggregate Index finished the quarter with a -1.02% return.

The bond market's negative return for the quarter occurred in the midst of rising yields and a reversal of the flight to quality evident in the previous quarter. As a result, treasuries lagged comparatively lower quality bond sectors. At the central bank's June meeting, though, the Fed held the funds rate steady amid speculation that it could begin raising rates as early as the fall to curb inflation. Short term rates at 2% while inflation is running at 4% has created an environment of negative real interest rates. Negative real interest rates encourage speculation because cash held in money markets cannot keep up with inflation. The only way to combat inflation is to raise rates. More than three quarters of the world's central banks have already done so. Central banks around the world will continue to face pressure to raise interest rates until we see a meaningful break in the trend of escalating commodity prices. Against this backdrop, we continue to be cautious toward the fixed income market in general. We prefer to be very selective in our purchases until such time the credit risks become clearer and the real rates of return are positive.

U.S. stocks rallied early in the quarter, but surging energy prices and continued weakness in the financial sector led to a dismal performance in June across the vast majority of world equity markets. European markets are down better than 15% YTD and the Asian markets are down nearly 20%. Hope that the worst of the credit crunch was over and that earnings growth would rebound as the year progressed failed to materialize. Hope quickly faded as the effects of the credit crisis continued, even as large amounts of capital were raised by financial institutions. Thus, the same problems that existed earlier this year; the banking crisis, falling home prices and rising inflation have yet to work their way through the system. These factors have pushed the index of consumers' expectations for the future to the lowest level ever. Such extreme negativity is probably one of the most bullish indicators in the equity market today. Excessive sentiment in either direction is usually indicative of a reversal on the horizon. Thus one should not be surprised to see the stock market have at a minimum, a reactionary bounce in the current quarter. The historic difficulty in timing the market suggests that one must weather these uncomfortable times in order to insure participation in the equity market's long term historical performance.

A handwritten signature in cursive script that reads "Frank M. Sterneck".

Frank Sterneck

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