



Year End Report 2009

The new Bull Market continued during the fourth quarter of 2009, essentially without interruption. The long awaited correction has not materialized. The market is exacting a major penalty on those who have left too much money parked in cash or bonds.

During the fourth quarter of 2009, the average of all portfolios appreciated by 6.8 percent (after commissions). Over the same period, the S&P 500 also increased by 6.8 percent. For all of 2009, the average portfolio appreciated by 26.2 percent (after commissions), while the S&P 500 index increased by 27.7 percent. Since we strongly outperformed the market during last years decline, a two year view is more instructive. Since January 1, 2008, the accounts have a net decline of 15.7 percent. Over the same time period, the S&P 500 index declined by 24.6 percent, and the Value Line Geometric index declined by 30.9 percent. We are now within shooting distance of our all time highs.

During the fourth quarter, we limited call writing to at most one position. Our nominal cash position declined a bit to 8 percent.

TIMING MODEL

The Timing Model strengthened in the fourth quarter. It moved up by five points to a bullish reading of 60%. Thus, it predicts a 60% chance of market appreciation and a 40% chance of market decline over the next 3 – 6 months.

2010 OUTLOOK

After four consecutive quarters of decline in US GDP, the third quarter of 2009 showed the first sign of economic growth. During the third quarter, the US economy grew at a 2.3 percent annual rate. The economic consensus is that fourth quarter US GDP growth could accelerate to about 3 percent. The consensus forecast for 2010 GDP growth is between 2.5 and 3 percent.

Over the past year, the Federal Reserve (FED) has kept short term interest rates close to zero, in order to help stimulate the economy. In addition, other federal programs such as “cash for clunkers” have helped stimulate economic growth. Thus, financial institutions have continued to repair their balance sheets. Unfortunately, there are still many write-offs that banks will have to take over the coming year. Going forward, bank lending will not be as robust as it has been in previous recoveries.

Commodity prices have increased by roughly 25 percent over the past year. However, they are not yet at levels that will stifle economic growth.

The housing correction appears to be over. Housing sales have been improving over the past eight months. In addition, housing prices have begun to improve slightly over the past three months. The bottom line, however, is that the average price of a house, across the US, has declined by roughly 30 percent over the past three years. This means that banks will still have to deal with numerous mortgage defaults over the coming year.

Finally, we need to look at the US consumer. Consumer sales represent roughly 65 percent of GDP growth. As I mentioned earlier, while housing prices have probably stopped falling, they are still about 30 percent below their peak values of 2006. Similarly, while the stock market has recovered about two thirds of the recent decline, many Americans have not participated in that recovery. Thus, the American consumer has lost a considerable amount of wealth. When one combines the asset losses with an unemployment rate of 10 percent, it is easy to conclude that the US consumer should be cautious over the coming year.

When I combine all these factors, I conclude that it is likely that the economic recovery will continue over the coming year. It is also likely that the recovery will be slower than previous recoveries. A GDP growth rate of say 3 percent will produce only gradual job growth. On the other hand, the stock market is a different animal than the economy. We are already in a Bull Market, and there is nothing in the above economic scenario that would change that. My experience tells me that, at present, market valuations are in a reasonable range. Even moderate GDP growth should produce a significant earnings advance for corporations that are presently very lean. My guess is that the US stock market could advance by roughly 10 – 15 percent over the coming year.

I wish you all a healthy and prosperous New Year, and thank you for your continued confidence.

Sincerely yours,

Ray Hofshi

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