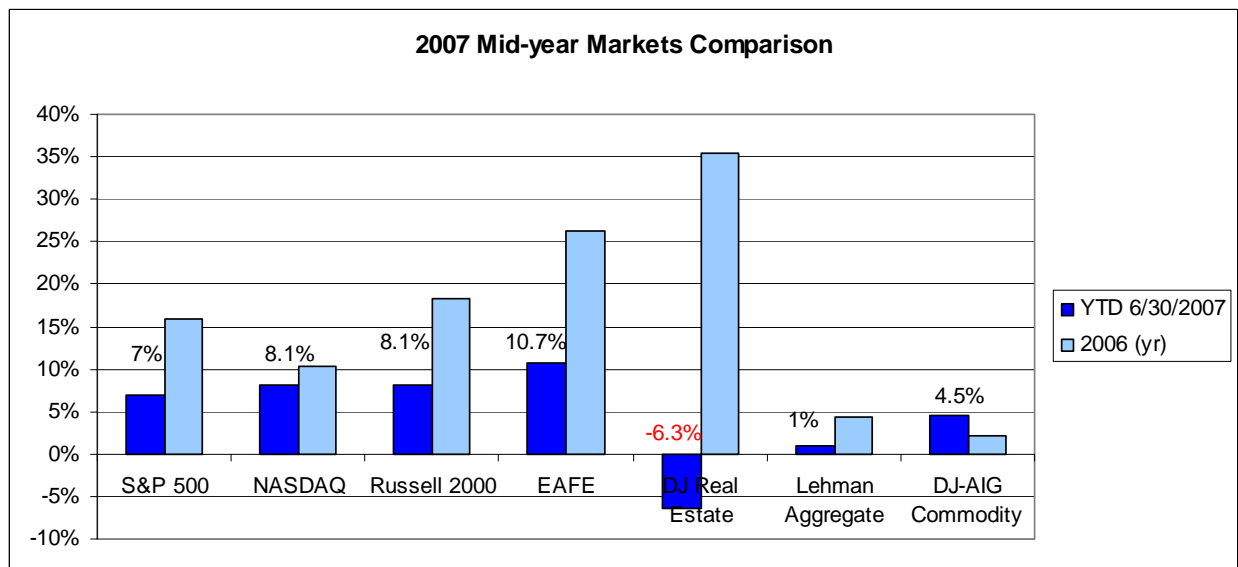




## Markets and Economic Summary & Outlook June 30, 2007

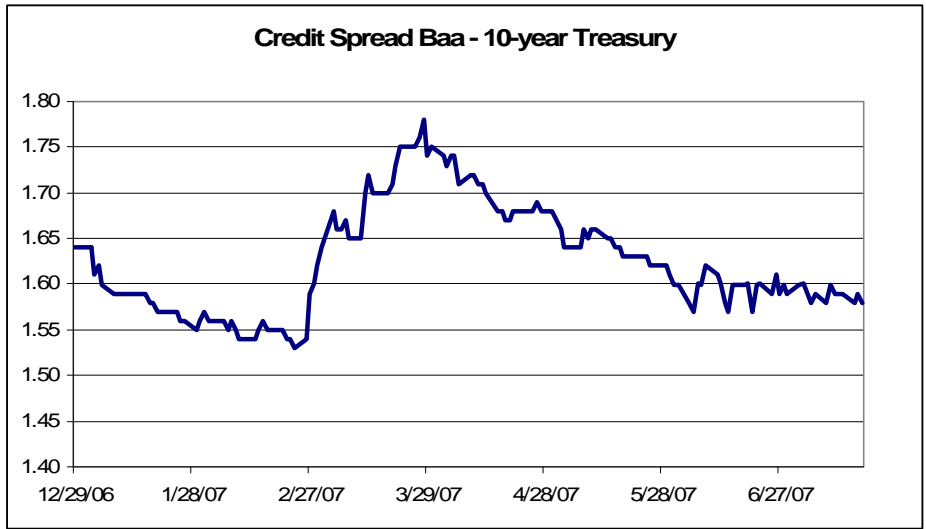
U.S. equities showed much improved performance during the second quarter of 2007 quarter. Most industry sectors demonstrated solid share price growth, notably energy, materials, industrials, and telecommunications. The technology sector also sprang to life, following several quarters of lackluster performance. IBM, the largest company within the sector, rose 12% during the second quarter. The S&P 500, comprised of large and mid cap U.S. stocks, was up **6.3%** (total return) during the second quarter (+0.6% in Q1 07), while the NASDAQ Composite performed slightly better, rising **7.3%** (+0.26% in Q1).

Non-U.S. equities, as measured by the MSCI EAFE index, continued to perform well rising **6.4%** during the second quarter 2007 (+4.1% in Q1). Approximately 1% of this return was attributable to a weaker U.S. dollar, therefore most non-U.S. markets posted good results in local currency terms.



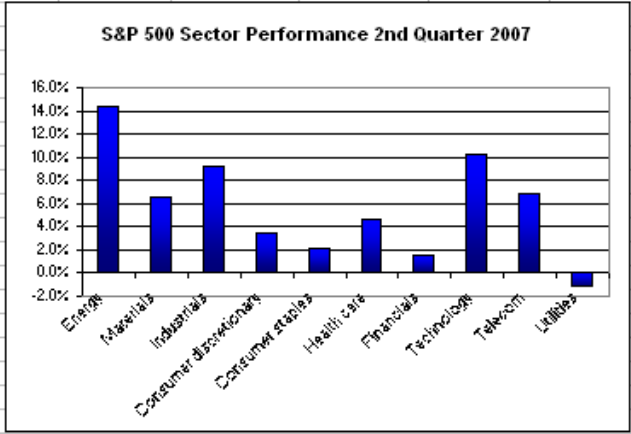
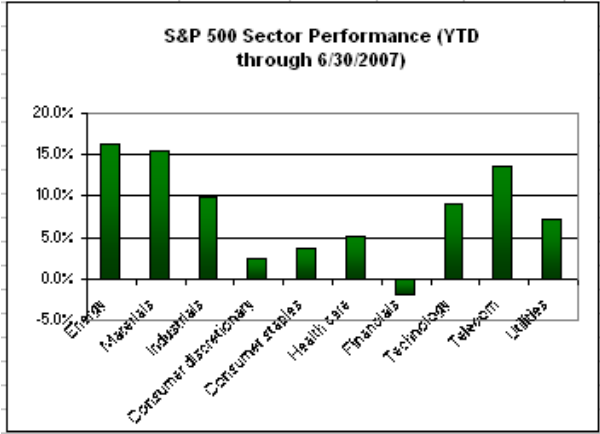
Total returns include capital gains and losses plus dividend and interest payments received and reinvested over the periods described. S&P 500 is an index of U.S. large and mid cap stocks; NASDAQ is the NASDAQ Composite Index; Russell 2000 is an index of U.S. small cap stocks; EAFE is an index of stocks from Europe, Australia, and Far East; DJ Real Estate is an index of traded U.S. REITs (real estate investment trusts); Lehman Aggregate is an index of U.S. Treasury, agency, and investment grade corporate bonds; DJ-AIG Commodity is a total return index of futures contracts on metal, agricultural, and energy commodities.

Alongside the good news in equities, there were several troubling signs that continued to play out and intensify during the second quarter. In general, it was a dismal quarter for investors holding bonds. The Lehman Bond Aggregate Index, a composite of U.S. Treasury, agency, and investment grade bonds, posted a -0.5% return during the second quarter. The yield on the 10-year Treasury rose 38 basis points (0.38%), which translated to price declines for most U.S. bonds having maturities greater than one year. Credit spreads also widened appreciably early on, but have tightened a bit since the beginning of the quarter (next chart). A credit spread is the difference between the yields (interest rates) between two bonds or classes of bonds.

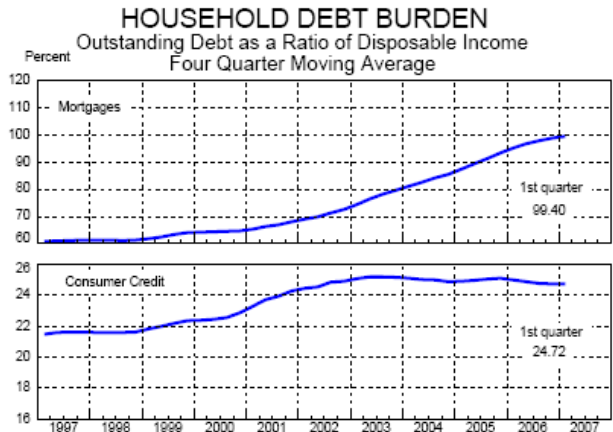
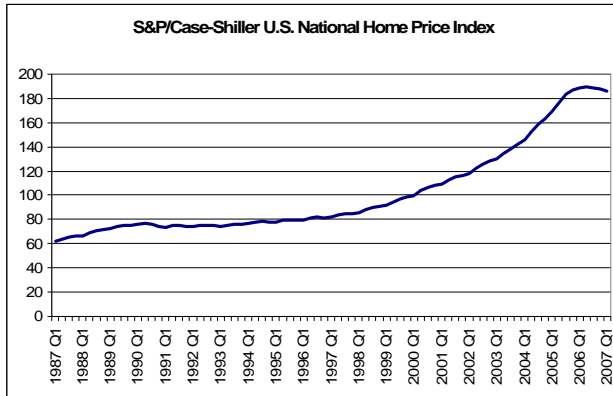


Average yield on Moody's Baa rated bonds minus the 10-year constant maturity U.S. Treasury.  
Source: Federal Reserve

The financial sector, the largest industry sector within the S&P 500, had a difficult and turbulent quarter, an undesirable trend that has picked up steam the last several weeks. The financial sector is down 2% year-to-date through June 30. Large investment banks, including underwriters such as Bear Stearns and Lehman Brothers, have taken some of the fallout from the sudden impairment of sub-prime mortgage bonds, and while not directly affected by sub-prime issues, the retail banks such as Wachovia and Bank of America have dragged due to investor concerns about the credit quality of other borrowers.



Most troubling is the continuing slide of residential home values in the U.S., where the median sales price of homes has dipped nationally for the first time since data has been available (over 30 years). Most banks are large holders of residential mortgages on their balance sheets, often as much as 80% to 90% of total assets. This includes both large and regional banks. Logically, a decline in the value of homes, the underlying collateral of mortgages, means that the mortgages held by banks are also worth slightly less. This, along with uneasiness that credit quality in general is starting to crack, has sent bank stock prices on a downward path these past several weeks.



Part of the problem, exacerbated by over-building, speculative buying, and too much unsold inventory, has been the very substantial increase in mortgage debt that has taken place the last five years. It's likely that the relatively recent ascent of housing prices and mortgage debt is attributable to greater availability of mortgage funding from banks and mortgage securities investors. Softness in housing prices could be a multi-year phenomenon now that funding standards have tightened across the board, and more importantly, as the average mortgage debt burden shifts downward to revert more closely to the historical norm.

Commercial real estate, as measured by the performance of the REIT sector (real estate investment trusts), was the most prominent sore spot illustrated on page one of this commentary. A negative 6.3% return the first half of the year for the Dow Jones Real Estate Index stands in sharp contrast to the +18% the index has returned the last five years (annualized). Commercial real estate values likely advanced too far, too fast, and the resulting correction has manifested itself in 2007. Fortunately, it appears that new construction and inventories are not a major issue, as has been the case in prior commercial real estate cycles.

Turning back to some good news, international equities continued to perform extremely well, continuing what is now a multi-year trend. Valuations still appear attractive in most countries, possibly with the exception of China and India where there appears an excess of stock market speculation that will contribute to large near-term volatility. The following chart illustrates the best performing global equity markets year-to-date.

There is an interesting mix of export-driven and industrialized service-oriented countries, indicating what is really unparalleled global growth spanning across all sectors. The exporters fall into two categories: 1) manufacturers and 2) resource owners. The export-oriented manufacturers listed on the following chart include South Korea and China. These countries, as well as the fully developed regions, require access to the substantial natural resources available from countries like Australia, Malaysia, and Canada, which not so coincidentally appear on this chart as well.

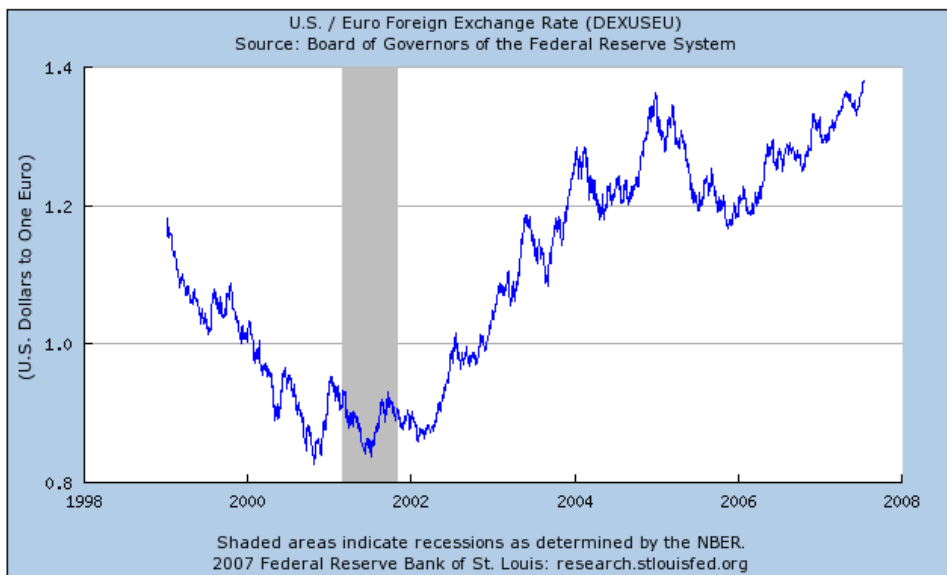
It may surprise some to see countries like Germany, the Netherlands, and Sweden on the chart. A weaker dollar plays a very small role in these countries' performance. It is more attributable to the activities of their industrial and engineering companies, which are heavily involved in large infrastructure projects in the Middle East and Asia. Infrastructure needs in the developing world will be a dominant theme for the next several years. Another



contributing factor has been the inevitable industry consolidation that is occurring as the European Union evolves from the dominance of state-centric companies to a more pan-European model. This consolidation trend has been mainly manifested in the utilities, telecommunications, and financial sectors.

Name	Return ▲
<b>Single Country</b>	
MSCI Brazil Index	+45.86%
MSCI Korea Index	+38.87%
MSCI Malaysia Index	+33.71%
MSCI Australia Index	+28.11%
MSCI Singapore Index	+27.19%
MSCI Canada Index	+27.15%
FTSE/Xinhua China 25 Index	+26.65%
MSCI Germany Index	+25.25%
MSCI Netherlands Index	+22.34%
MSCI Mexico Index	+21.35%
MSCI Sweden Index	+18.78%
MSCI Taiwan Index	+18.28%

Source: Barclay's Global Investors (through July 20, 2007)





## Mid-2007 Outlook Update

We remain optimistic headed into the second half of 2007, tempered by the uncertain path of consumer sentiment this fall. The issues described earlier surrounding U.S. residential housing will have some impact on consumers, although not as large as one might expect. It's important to remember that every one needs to live somewhere, so housing demand will not completely dry up. The silver lining in all this is that household debt service for housing should decline, which frees up funds for other purchases. We're witnessing a necessary slowdown in what was an unsustainable, white-hot market.

Capital goods orders from the global manufacturing sector appear to be on an upward swing driven by many countries' continuing infrastructure needs. Interest rates globally and in the U.S. are still relatively low, therefore credit availability for the creditworthy should not be too great an issue. The rising cost of energy obviously remains a wild card, and this next heating season could prove a real test of consumer nerves, and some behavioral adjustment will be required. Alternative energy will provide little or near-term relief, therefore the current trading band for the price of oil is what it is. Nevertheless, on balance, there are quite a few good reasons to maintain optimistic about prospects for equities in the months ahead.

### Portfolio implications for the next 6 to 12 months

- U.S. equities continue to remain reasonably valued relative to historical standards. Quarterly corporate earnings and cash flow remain strong and have been the driving force of current stock market performance. The positive influence of these factors contrasts with earlier periods of positive returns that were underpinned more by wishful thinking (think dot.com) rather than actual cash flow generation.
- The following chart illustrates the average price/earnings ratio for the S&P 500 (blue line), which hovers near its ten-year low, although this has trended up slightly the past two quarters. Sectors that still appear attractive from a valuation perspective include industrials, materials, and technology.





- We are taking an increasingly cautious and wary view of the developments affecting financial stocks, in order of concern, investment banks, regional banks, and the large banks. Investment banks because of slowdowns in their fixed income businesses, unknown liabilities from past deals, and hedge fund exposure. Regional banks because of nearly 100% reliance on mortgage, and worse, construction lending. The large national banks, while generally not quite as reliant on mortgage lending, still feel the pain of a slowdown from the go-go years. While beyond the scope of this commentary, it is almost guaranteed that issues have yet to surface concerning CDOs and CLOs, which were often unwritten based on uncertain and untested valuation models and wishful thinking. Insurance companies cause less concern at the moment and appear to not have been large buyers, for the most part, of sub-prime debt, CDOs (collateralized debt obligations), and CLOs (collateralized loan obligations).
- Dividends remain an important determinant in maximizing total return, therefore, companies that pay qualifying corporate dividends (15% federal rate) and that have substantial free cash flow are always favorites on our screen. Investors should be aware that dividends from most non-U.S. companies qualify for the favored 15% tax rate. There remain attractive dividend opportunities in the U.S. and outside our borders.
- We remain on the alert for attractively valued, export-oriented companies globally. Opportunities clearly remain amongst industrial, materials, and technology companies with the expertise, products and resources required to meet rising global demand for infrastructure.
- Energy is a prime example of a sector with extremely large infrastructure requirements on a global basis, whether it be advanced drilling technologies, pipelines, other transportation, and refining. It is prudent to maintain a healthy exposure to the energy sector in exploration and production, refining, and related infrastructure. In the U.S., we require approximately 15 million barrels of crude oil a day. Ten years ago the U.S. was producing 10 million barrels a day, in 2007 we're down to producing 5 million barrels a day. This gap is made up by imports, and fortunately our largest sources are close by in Canada and Mexico. Other areas of growing importance for growing supply include Brazil and Argentina. Given the uncertainty and geopolitical risk in other regions, it seems reasonable to assume these countries will continue to offer investors unique opportunities. U.S. domestic producers, particularly those more adept at employing new technologies, should also more likely provide excess returns.
- Our working assumption for U.S. interest rates calls for the Federal Reserve to maintain its current interest rate posture for the next six months (5.25% target Fed funds rate). All bets are off, however, should there be large spike in oil this fall or winter. The inflationary pressure will be too great and the Fed will be forced to take action by raising the Fed funds target.



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