

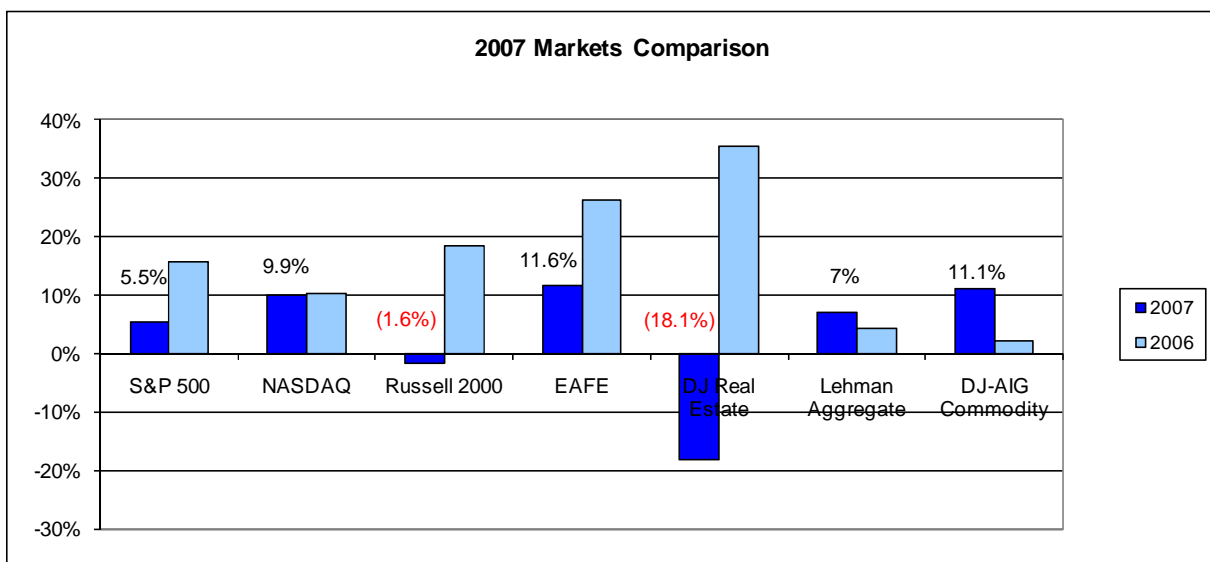


Markets and Economic Summary & Outlook December 31, 2007

U.S. and many foreign equity markets ended the year on a sour note, and spilled over into first weeks of 2008. Fear of an economic slowdown in the U.S. owing to declining home values and deteriorating consumer sentiment has clearly impacted short-term market performance. The U.S. financial and consumer discretionary (retail, autos) sectors to no one's surprise fared well during the fourth quarter 2007, and both were down over 10% for the period. Not all U.S. sectors suffered, however, as the energy, utilities, and consumer staples sectors posted reasonable gains, solidifying good returns for the year as a whole. The S&P 500, comprised of large and mid cap U.S. stocks, was down **-3.3%** (total return including dividends) during the fourth quarter (vs. +2% in Q3 07), while the NASDAQ Composite also lost ground, dropping **-1.8%** (vs. +4% in Q3).

The S&P 500 and the NASDAQ Composite for the full-year 2007 were up **+5.5%** and **+9.9%**, respectively. The NASDAQ's annual performance benefited from a rebound in technology stocks in 2007. Unfortunately, most of the technology gain has vanished since year-end.

Non-U.S. equities, as measured by the MSCI EAFE index, had their first decline in recent memory, falling **-1.7%** during the fourth quarter 2007 (vs. +2.2% in Q3). The fourth quarter decline was not across the board, and some non-U.S. markets fared very well including Brazil (+13.2%), Germany (+5.1%), and Spain (+8.3%). Small cap stocks, as measured by the Russell 2000, were a disappointment for the quarter and the year, retreating **-4.6%** during the quarter (vs. -3.1% in Q3). The biggest chill, however, was felt in commercial real estate where REITs fell **-12.6%** during the quarter (vs. flat in Q3 as measured by the DJ Real Estate Index). REITs have fallen another 10% since year-end, an indicator of more trouble ahead for the banks as they are forced to face up to growing problems in their commercial real estate loan portfolios.

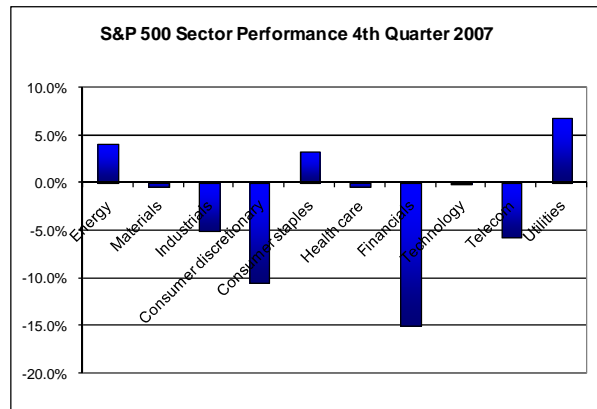
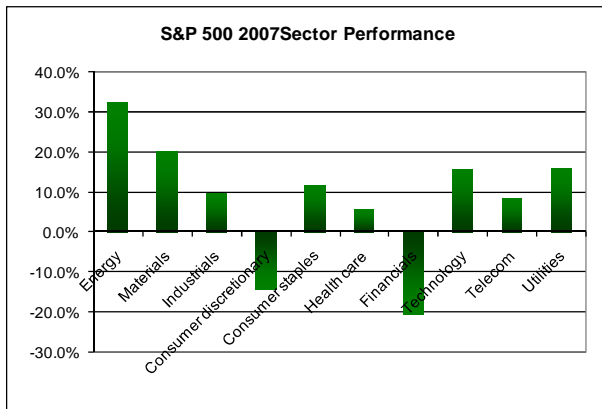


Total returns include capital gains and losses plus dividend and interest payments received and reinvested over the periods described. S&P 500 is an index of U.S. large and mid cap stocks; NASDAQ is the NASDAQ Composite Index; Russell 2000 is an index of U.S. small cap stocks; EAFE is an index of stocks 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.

Investment grade bonds (+7% in 2007) and commodities (+11.1% in 2007) bucked the trend in equities, doing very well in the fourth quarter and full year, again demonstrating the benefit of being negatively correlated to equities. Recession fears, Fed rate cuts, and a flight to safety have driven short to intermediate Treasury yields sharply lower. The 10-year Treasury now stands at 3.6%, not leaving much leeway for lower interest rates. Exceptionally low yields on high quality bonds will make life more difficult for income-oriented investors, and the search for yield will lead to higher yielding alternatives. Several key commodities experienced price spikes in 2007, most notably crude oil (+40%), wheat (+52%), soybeans (+54%), and gold (+24%). Interesting, corn was down -2%, mainly because farmers over-planted the crop anticipating higher prices driven by ethanol demand.















The negative effects from a hangover in the financial sector cannot be overemphasized. The financials are the largest single sector in the U.S. stock market, for example, by comparison it is five times larger than either the telecom or utilities sectors. The most recent write-downs are mainly attributable to exotic and miss-priced securities comprised of sub-prime or alt-A mortgages. However, there are other problems that have fully yet to surface. These include in no particular order an unusual abundance of loans and high yield bonds used to finance highly leveraged private equity deals the past two years, CDOs (collateralized debt obligations) that are comprised of these same loans and bonds, over-priced and over-leveraged commercial real estate, and the likelihood of rising defaults among previously creditworthy consumers in mortgages, credit cards, and auto loans.

These problems have occurred in other previous banking cycles, but not to the scale we're seeing in the credit markets today. Tricky accounting and new instruments have again gotten the better of the bank and securities regulators. To be fair, the emergence of unregulated hedge funds as originators of some the newer, more toxic financial innovations are a new element to be reckoned with.

The best performing equity markets in 2007 outside the U.S. were spread amongst selected fast growing, export-oriented economies like China and South Korea, and more balanced and steady commodity-rich countries such as Brazil, Malaysia, Canada, and Australia. The following graph,



which summarizes performance over the entire year, masks a pullback during the second half of the year among some of the export-growth countries, for example, South Korea (-4.6% Q4) and China (-2.8% Q4). China, which ended the year up 56%, was up nearly 100% near mid-year, marking a fairly sharp drop from its high for the year. Continued weakness likely signals an expected slowdown in global consumer spending.

Name	Return ▲
Single Country	
MSCI Brazil Index(SM)	+79.56% 
FTSE/Xinhua China 25 Index	+55.99% 
MSCI Malaysia Index	+46.07% 
MSCI Hong Kong Index	+41.20% 
MSCI Germany Index	+35.21% 
MSCI Korea Index(SM)	+31.85% 
MSCI Canada Index	+29.57% 
MSCI Singapore Index	+28.35% 
MSCI Australia Index	+28.34% 
MSCI Spain Index	+23.95% 
MSCI Chile Investable Market Index	+23.58% 
MSCI Netherlands Index	+20.59% 

Source: Barclay's Global Investors (full year 2007)



Early 2008 Outlook Update

Clearly, equity markets have gotten off on the wrong foot in January. Fear of a consumer spending slowdown and heightened risk of recession in the U.S. have soured market sentiment. Sentiment, however, can be a fleeting thing, and the direction could change quickly given meaningful rate cuts by the Fed and signs that the banks have taken the appropriate steps to get the majority of problems behind them. While it's always a good idea to review portfolio positioning at regular intervals, now is an especially good time to consider if a more defensive posture is warranted.

The current economic context is very different from what we experienced near the end of 2000, the tipping point of our last recession. The following table highlights and reminds us of several key differences in market conditions between then and now:

	Dec 2000	2007 (Nov/Dec)	2007 trend
S&P 500 average P/E ratio	30	17.5	flat
3-month Treasury yield	5.77%	3%	down
10-year Treasury yield	5.24%	4.10%	down
CPI (all items)	3.40%	4.10%	Up slightly
Unemployment rate	3.90%	5%	Up
\$/Euro	0.8983	1.4559	Up
UM consumer sentiment	98.4	76.0	down

One could almost imagine, assuming you hadn't looked at the news in a year, that we're already in recession based on these few indicators. Consumer sentiment (University of Michigan survey), which fell sharply during the fourth quarter, and the S&P 500's average P/E ratio both are near 10-year lows. Unemployment is ticking up and no one needs to be reminded of the unprecedented declines in residential construction and median home prices in the U.S.

Portfolio implications for the next 6 to 12 months

- U.S. equity valuations appear extremely attractive, as long as corporate earnings remain stable to up. Bank earnings have been abysmal this reporting season, but other industries' earnings have been holding up for the most part. There are many interesting opportunities for the patient, intermediate to long-term equity investor during this pullback, most notably within the energy, materials, and technology sectors.
- Defensive-oriented equity investors might also consider certain sub-sectors within health care and utilities. Managed care and some specialty treatment providers are areas worth examining. Managed care is interesting play in this environment given expected continuing strong cash flow, low debt, and perceived need whether there be good times or bad. Growing unemployment and other risks, for example, the outcome of the presidential election must be weighed in any analysis.



- Earnings in the financial sector have taken a dramatic hit this quarter, and this situation has the potential to worsen before it gets better. There is absolutely no reason to think the housing market will experience any short-term relief from additional rate cuts or a government stimulus package. There is simply too much excess inventory and home prices are still too high. Rent/to own and mortgage debt/disposable income ratios remain substantially above historic norms. It's best for most investors to avoid the banking sector until all issues, including the potential problems cited earlier, are disclosed and strategies are restored for a return to normal banking operations.
- At some point, perhaps as early as mid-2008, there may be unique and very rewarding opportunities to re-enter the financial space. The recent steepening of the yield curve also works to banks' favor as they get back to basics (borrow short/lend long). Credit cycles come and go, and this one is no exception. Today's problems and economic after effects may appear breathtakingly large, but they are surmountable, and banks of all sizes will continue to do business and thrive, with the possible exception of one or two large failures that receive just punishment for irrational lending practices and poor risk management.
- The Fed is expected to lower interest rates in the coming weeks, which should contribute to a weakening of an already weak dollar. The currency aspect is secondary benefit when evaluating non-U.S. equities, nevertheless, this is an additional consideration to take into account particularly when looking at some non-U.S. markets that have pulled back the past couple of weeks. Australia comes to mind given its substantial natural resource base and proximity to the Asian manufacturing complex.
- The best advice to the bond investor seems obvious. Stick with investment grade securities, avoid most of the high yield sector, and expect a nice present when the Fed cuts the Fed funds rate. The high yield default rate will surely rise, and rise abruptly, over the next twelve months, especially among the more margin private equity deals done the past couple of years. Bonds are currently an interesting means for some investors considering the financial sector. Credit spreads for what appear to be near-certain survivors are quite wide at the moment. A diversified mix of bank bonds with balanced business segments and could yield nice returns over the next two to three years. Just goes to show, there's no shortage of good ideas to consider no matter the situation.

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