



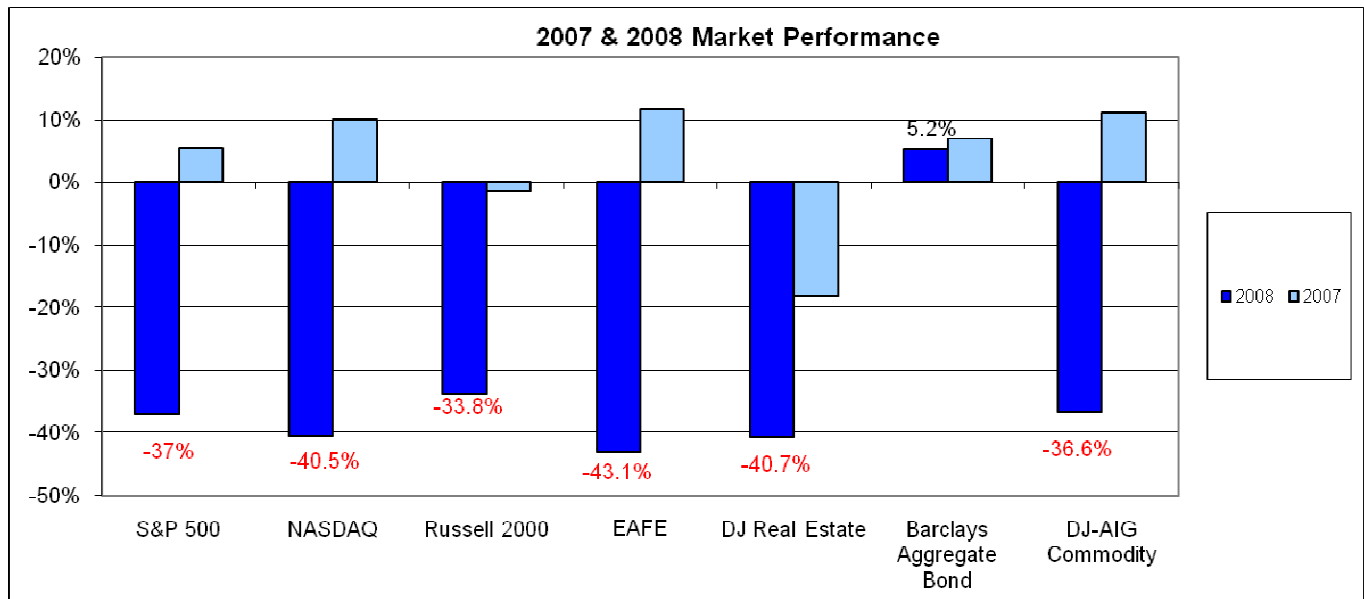
Markets and Economic Summary & Outlook

Year-to-date through December 31, 2008

Global equity markets deteriorated rapidly early in the fourth quarter of 2008, continuing a trend that began in September. This has been one of the worst periods on record since the 1930's. The S&P 500, comprised of U.S. large and mid-cap stocks, declined **8.9%** in September, **16.8%** in October, **7.2%** in November, and was up **1.1%** in December, benefiting from a brief rally the last few days of the year. All industry sectors were deep in the red by the end of 2008, the best being consumer staples down **17.7%** and the worst, not surprisingly, was turned in by the financial sector, which was down a mind boggling **57%**.

The S&P 500 fell **21.9%** (total return including dividends) during the fourth quarter (**-37%** for the year), and the NASDAQ Composite dropped **24.3%** (even worse, **-40.5%** for the year). Non-U.S. equities, measured by the MSCI EAFE index, fell **19.9%** during the quarter (**-43.1%** for the year). Most Asian and European markets are now down 35% to 60% for the year. Commercial real estate, as measured by REITs (real estate investment trusts), which had been down only **2.5%** through September 30th, tumbled over **38%** during the fourth quarter.

Bonds, and most notably U.S. Treasuries, were the only asset class to escape the carnage. The Barclays Aggregate Bond Index (formerly the Lehman Aggregate) was up **5.2%** for the year. Treasuries and AAA-rated agency debt comprises 75% of the Barclays Aggregate, and these securities performed very well in stark contrast to equities. The 10-year Treasury yield fell as low as 2% in recent weeks, and this in itself has created worries about a new bubble, this time in Treasury bonds.

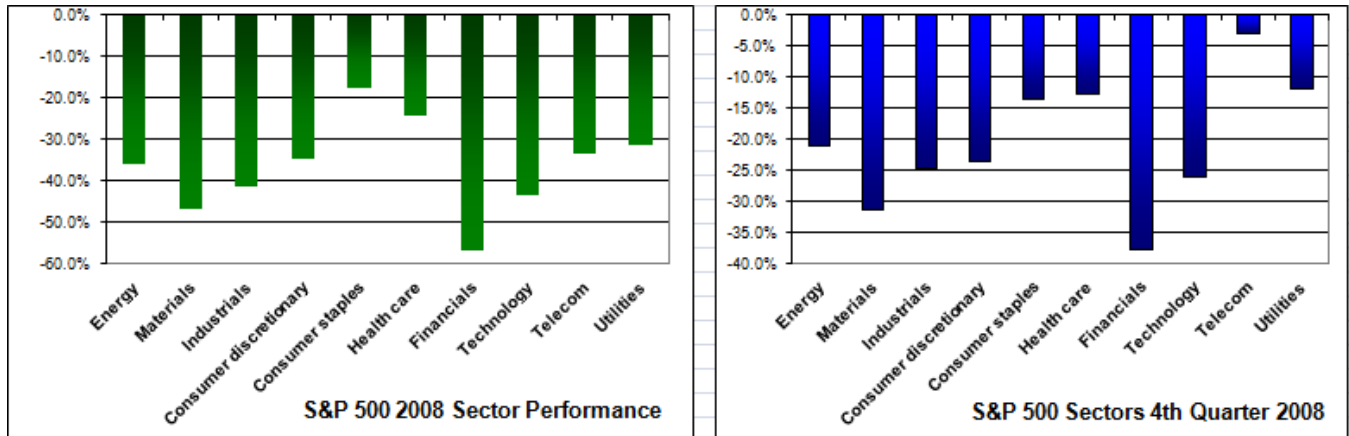


Total returns include capital gains and losses plus dividend and interest payments received and reinvested over the periods described. S&P 500 is an index of U.S. large and mid cap stocks; NASDAQ is the NASDAQ Composite Index; Russell 2000 is an index of U.S. small cap stocks; EAFE is an index of stocks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

All U.S. industry sectors were in negative territory during the fourth quarter (lower right chart), with financials, technology, and materials companies leading the way down. Telecom, for no apparent reason, fared much better, and was down only 3% for the quarter. For the whole year, however, the telecom sector was down over 30%.



Investors in most non-U.S. equity markets earned excellent returns over the last five years, however most of these markets performed significantly worse compared to the U.S. in 2008. The unexpected strengthening of the dollar in 2008 was also a contributing factor. The worst performing markets in 2008 were Austria, Belgium, and Turkey, all down over 60%, followed by Brazil, Korea, Hong Kong, and Australia, which were down 56% to 51% in order.

Best Performing Non-U.S. Equity Markets

Most recent 5-year annualized returns

MSCI Brazil Index(SM) (01/06/2009)	+21.39%
MSCI Mexico Investable Market Index (01/06/2009)	+14.09%
FTSE/Xinhua China 25 Index (01/07/2009)	+11.56%
MSCI South Africa Index (01/06/2009)	+10.62%
MSCI Chile Investable Market Index (01/06/2009)	+9.89%
MSCI Malaysia Index (01/06/2009)	+7.84%
MSCI Spain Index (01/06/2009)	+7.80%
MSCI Singapore Index (01/06/2009)	+7.30%
MSCI Canada Index (01/06/2009)	+6.99%
MSCI Turkey Investable Market Index (01/06/2009)	+6.49%
MSCI Korea Index(SM) (01/06/2009)	+5.10%

2008 best foreign market returns

MSCI Japan Small Cap Index	-21.15%
MSCI Japan Index(SM)	-29.21%
MSCI Switzerland Index	-30.49%
MSCI Chile Investable Market Index	-37.50%
MSCI South Africa Index	-37.89%
MSCI Israel Capped Investable Market Index	-39.71%
MSCI Spain Index	-40.60%
MSCI Malaysia Index	-41.21%
MSCI France Index	-43.27%
MSCI Mexico Investable Market Index	-43.51%
MSCI Canada Index	-45.51%

Source: Barclay's Global Investors (through December 31, 2008)



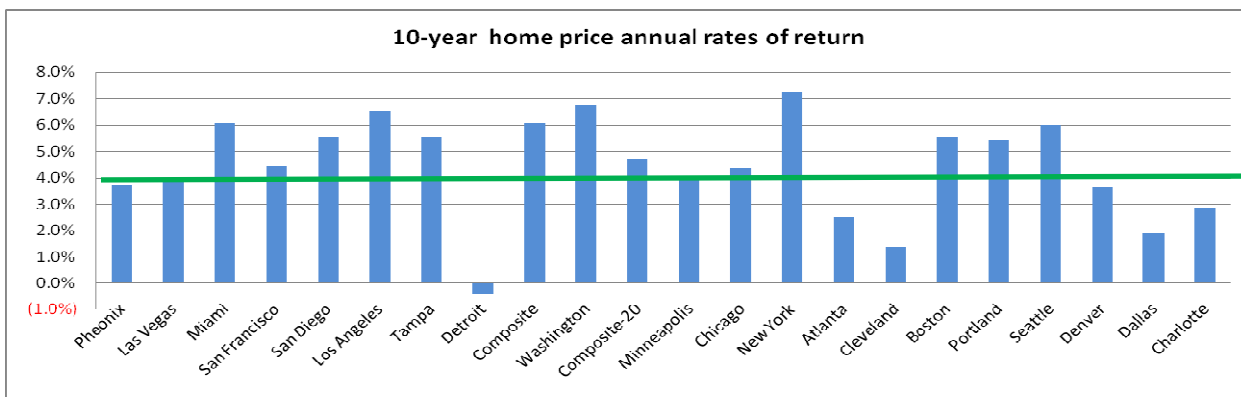
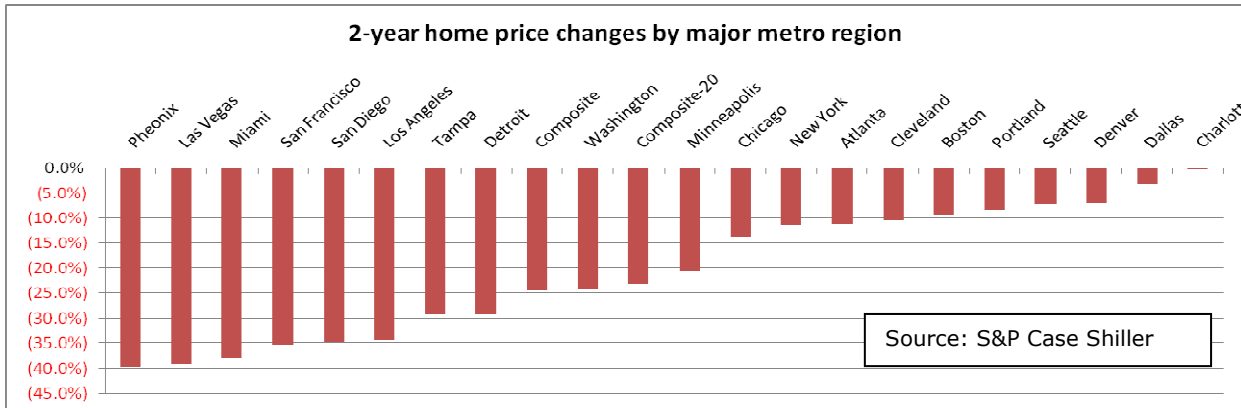
First Quarter 2009 Outlook

On November 28, 2008 the National Bureau of Economic Research declared that the U.S. has been in recession since December 2007, therefore we are over one year into the current economic contraction, and it appears this could continue for a minimum of one to two quarters more. It's possible that we could be on track for the longest recession on record since WWII. A recession is defined as the period from the peak (highest point of economic expansion) to trough (the point at which the economy starts to again expand) in the business cycle. The '73-'75 and '81-'82 recessions were previously the longest with each lasting 16 months. For the record, the '29-'33 recession, the beginning of the Great Depression, lasted 43 months.

Clearly, there is little in the way of good news on the economic front, and there is no reason to sugar coat the current situation. The recession appears to be driven mainly by reduced consumer spending. Sales of durable goods were down 15% in the third quarter, and the fourth quarter number will likely be even worse when it's reported. Sales of automobiles are down on average 35% for all manufacturers, and most retailers are seeing sales declines ranging from 5% to as much as 20%. A significant portion of the retail sector now appears to face heightened bankruptcy risk, which would not bode well for employment or commercial real estate.

The consumer has been hit by the double whammy of falling home and stock prices, which has led to a reduction in household net worth and the "wealth effect" that people feel. Some semblance of stability in home prices is critical to future recovery. The following two charts highlight the current state of home prices in the U.S. California, Florida, Arizona, and Nevada have absorbed the most punishment to date. Historically, and prior to 1997, home prices nationally on average rose **4%** per year, but jumped to **10%** a year from 1997 to the peak in June 2006. The correction has been going on nearly three years, and our best case scenario would call for another 10% decline in the national median price in 2009 on top of the 25% decline that's already occurred since 2006. A worst case scenario could see home prices overshooting the aggregate 35% decline, perhaps dropping an additional 10% to 15% and extending into 2011. The latter scenario would create even greater foreclosure distress and force significantly higher writedowns by mortgage noteholders.

Home price deflation is not limited to the U.S. There are other housing bubble markets, which are also experiencing similar corrections, most notably the U.K., Ireland, Spain, Australia, and New Zealand. By way of comparison, there are credible forecasts of up to an 80% decline in home prices in Ireland. The Irish banking system would in effect be nationalized as a result. One could also expect the correction to take hold in other "hot" residential and commercial property markets like Hong Kong and other parts of China.



The reported U.S. unemployment rate stood at 6.7% at the end of November, but if one adds part-timers looking for full-time work and those who've stopped looking, the rate is closer to 10%. The near 40% decline in equities in 2008 would imply the reported unemployment rate eventually rising to 10% or more, which has happened only once since WWII (1982). California, which accounts for 20% of the U.S. economy, already has a 9% unemployment rate, and it's still rising. Near-term consumer spending consequently we would expect to be quite muted.

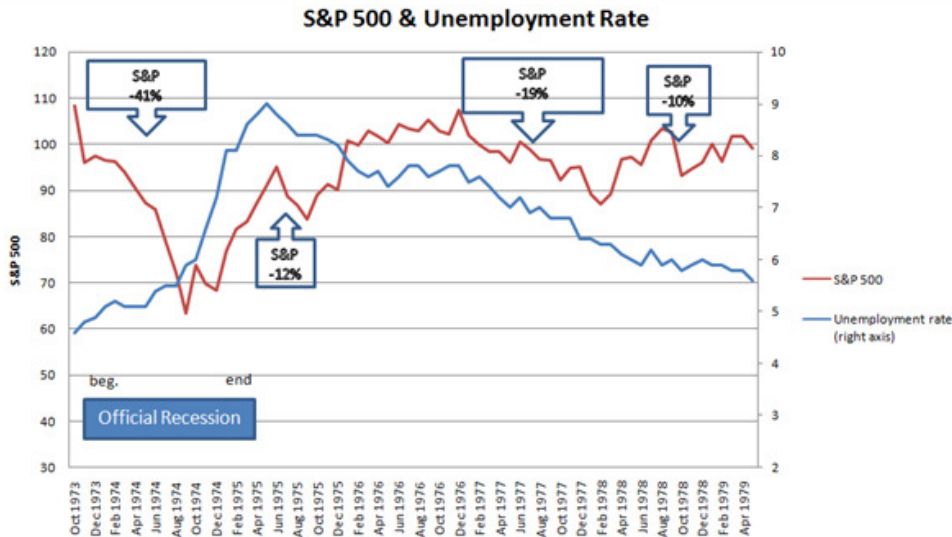
So, the \$64,000 question is, "What's going to happen?" In short, anything can happen. There is a range of possible outcomes, and timing is difficult if not impossible. The promise of a trillion dollar stimulus package from the incoming administration doesn't seem to have made much of a positive impact on the equity market, although volatility has abated a bit the last several weeks (it could return). There is some disagreement whether government stimulus actually works. Some studies (Blanchard and Perotti) have shown that past government stimulus packages added only \$1 for each \$1 borrowed and spent, therefore the net effect being \$0 in growth. This might partly explain the market's so far underwhelming reaction to the proposed package.

An examination of each recession since 1950 (eight in total excluding the current one) has shown that about half way through the reported recession the stock market hits bottom and then begins to recover. Full recovery in equities (S&P 500) took from 3 to 27 months from each recession's midpoint, even as unemployment and sentiment continued to worsen. The chart below illustrates what happened to stocks and unemployment around the 1973-1975 recession, the worst since WWII. There was a 41% decline in the S&P 500 from October 1973 through September 1974, which was about the mid-point of the officially reported recession. Starting in September, the S&P



500 (red line) started to track upward, with some down months along the way, toward full recovery by December 1976, a period of 27 months.

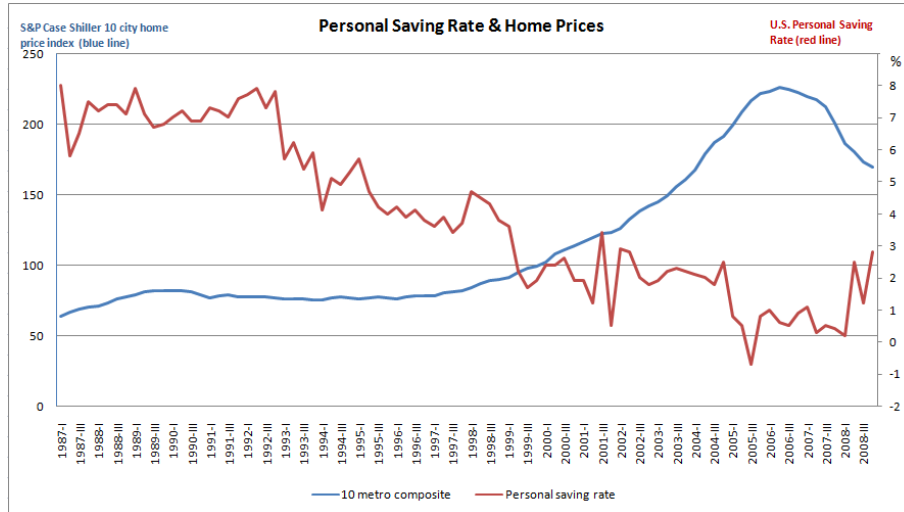
1973 – 1975 U.S. Recession



Availability of credit doesn't seem to be nearly the problem it was three months ago. Short-term lending has freed up (3-month LIBOR is near 1%, down from over 5% at the height of the crisis), and investment grade companies thus far in January have successfully sold a very large volume of new bonds. Some of the characteristics of our current situation that are indeed different from the rest of the post-WWII era include an unusually large budget deficit relative to GDP (and, by all accounts, we expect this will become even larger the next two years), greater risk of harmful asset deflation, and a still very shaky financial sector.

Clearly, this time things could be different, but economic contractions in the past have forced reductions in excess capacity, promoted greater efficiencies, and ultimately led to our emerging a bit stronger. The final chart (see below) illustrates one positive from the current moment. One of the really big problems the U.S. economy has faced the last ten or fifteen years has been the very low personal savings rate (what we earn minus things we spend money on), which even went negative in 2005 (that's right, Americans borrowed more than they saved). The contraction in consumer expenditures the past few months has led to an uptick in the PSR (personal savings rate), which is near 3% right now.

The PSR mysteriously declined consistently throughout the 1990's right up to 2008. The decline in savings was opposite the explosion in home prices over the period, not surprising since many Americans thought their homes were the solutions to their retirement plans. That's not worked out, not unlike the tech bubble leading up to 2001. The PSR still needs to rise well above 3% to reach the healthier 8% to 10% savings rates seen in the '50's through the early '80's, but we may get there yet in this new era of intense frugality. This would be good because it could mean more domestic-sourced, low cost funding available for productive capital investments, and people would ultimately be far less reliant on structures they have no personal control over like pensions and Social Security to meet retirement needs.



Portfolio Implications for Early 2009

- New investments directed at equities should be approached with caution and with full consideration of one's time horizon. Mentioned previously, timing a market bottom with any precision is impossible. A ten+ year time horizon is very different from a need two or three years from now. When examining equities for investment at this time, we tend to focus on companies with the following attributes: low debt, expected positive free cash flow even in a difficult environment, payment of a dividend that appears sustainable, low price to earnings and cash flow ratios, consumer staples or necessities, presence of strong brands with loyal customers, and leaders within industry sectors. No matter what you hear, nothing is recession proof, but it likely will pay to be patient at these valuations for good companies.
- It's never a bad time to review your asset allocation. One implication of the current difficulties has been significantly higher yields on investment grade corporate debt. Bonds that yielded as little as 4% in early 2008, saw these yields rise to the 7% to even 10% range late in the year. Selected corporate and municipal bonds in short to intermediate maturities still look attractive today. As a footnote, yields on CT state and municipal bonds have not risen to the degree seen in some other states due to relatively less muni debt available relative to a high number of high tax bracket investors.
- We would council avoiding certain sectors for the time being. Emerging markets, either commodity (e.g., Brazil) or export reliant (e.g., China), should be avoided in our opinion. There was a myth going around about economic "decoupling" where somehow other countries would be able to avoid a slowdown in the U.S. and even continue to grow. There appears to be significant risk of sovereign debt defaults in the coming months (Eastern Europe & Latin America).
- In the U.S., we'd recommend avoiding sectors where excess capacity will be ruthlessly eliminated. Homebuilders, retail, and REITs immediately spring to mind. Those not opposed to some risk might consider putting their toe in the water with a financial name or two at these prices, fully acknowledging potentially sizable short-term volatility. Government guarantees are worth something.



- Those sticking with Treasuries might be in for a nasty surprise in the next few months. One would think that a 2.1% yield on a 10-year Treasury cannot last forever, particularly when the Federal government really revs up the money printing machine. We expect new Treasury bonds to add 50% to 75% to the national debt over the next couple of years. Yields will have to rise to absorb this very abundant new supply. Many are arguing that the dollar could be severely devalued in the process, but nearly every country is in the same contractionary boat, and all will be madly trying to spend their way out of their own messes. Higher yields on Treasuries could also provide some needed dollar support, as well.
- While asset deflation that could spiral out of control warrants immediate concern, inflation could become a severe problem looking out a year or two (again, rates should rise) due to the money printing machine. Floating rate bonds and TIPS (Treasury Inflation Protection Securities) might be good candidates to take advantage of this intermediate opportunity.

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