



October 10, 2008

During the third quarter of 2008, the stock market continued to decline. The market has now declined by more than 30 percent from last year's highs. As I write this report, the selling is approaching panic levels. Most of this week's concern is being caused by the freezing up of the commercial short-term paper markets. Due to the passage of the financial rescue bill in Congress, I believe that the Treasury and the Federal Reserve have the tools necessary to re-liquefy the banking system and keep the economy moving. The good news is that the market now appears to be extremely cheap and that, in the not-too-distant future, we should be able to employ our cash to buy additional equity positions at very low prices.

My strategy during the third quarter was to continue selectively selling covered calls. I am only selling calls on those stocks which are reasonably close to their "fair market value". This allows us to increase our cash position without giving away much of our upside potential. We are not selling calls on any of our deeply discounted stocks. At times like this cash is king. Our long – term net worth will be enhanced by our ability to properly invest this cash at or near this market bottom. At the end of the third quarter, our average cash position was roughly 15 percent.

TIMING MODEL

The Timing model remained at the same Bear Market level as last quarter's (a reading of 40%). While we recognize that there are already some extraordinary values around, we will not commit our cash reserves until the Timing Model turns positive.

MARKET OUTLOOK

Over the past year, the Federal Reserve Bank has lowered the Fed Funds rate from 4.75 percent to 2.0 percent. The Fed Funds rate essentially establishes a basis for short-term interest rates across the US economy. Thus, a major component for the next economic upturn in the US economy is already in place. It is likely that we will have one more reduction in the Fed Funds rate before the recovery.

The second major component needed for the next upturn is also in place. The price of oil has declined from a high of \$147/ barrel to about \$90/barrel. While \$90/barrel is still high by historical standards, this enormous decline will be stimulative to the economy (assuming the price does not bounce back up). Furthermore, most other commodities (from corn to steel) have also come back down to earth. Hopefully, commodity prices will come down a bit more before the next economic expansion.

The fly in the ointment appears to be the housing market, and what the deterioration of housing prices has done to our financial system. Housing prices have now declined about 22 percent (average across the country) over the past two years. According to my calculations this brings average housing prices back to a reasonable level (i.e. back to their long – term trend line). Thus, housing prices may be close to stability. Unfortunately, economic systems are not always rational; they tend to overshoot on the up – side, and fall too far on the down –side. The implication is that we may still have some moderate decline left in the housing market.

Finally, the damage to our financial system has been real and substantial. Much of the debt that greased the financial (credit) system, used housing as collateral. The collapse of that debt has made it very difficult for financial institutions to provide credit to banks, businesses, homeowners, etc. Obviously, the economy can not move forward without this credit. I am confident that the Treasury and the Federal Reserve Bank have sufficient knowledge and capability to re-liquefy the US financial system (especially now that Congress has passed the rescue package). The Fed and the Treasury will need to work with their counterparts around the world to keep global credit flowing.

I believe that at the present time, it is primarily market psychology (panic), rather than fundamentals, that is driving the stock market. The tight credit of the financial markets may finally cause the recession that everyone has been talking about – but there appears to be a disconnect between our economic situation and present stock prices. For those with some courage, this could be an opportunity that occurs roughly once every twenty five years to buy companies at distressed levels.

Sincerely yours,

Ray Hofshi

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