



July 24, 2009

Second Quarter Market Summary – Dr. Ray Hofshi

The Timing Model predicted a probable bottom to the stock market during the first quarter. That prediction was reinforced by the positive movement of the market during the second quarter. The market has now assimilated the information, that the probability of a depression has been reduced to almost zero. In spite of the recent market bounce, we need to remember that most market indices are still roughly 40 percent below their peaks of 2007. Present market levels are consistent with the reality that we are at the tail end of the worst global recession since World War II.

Portfolio actions taken during the second quarter include the sale of Ceradyne. Ceradyne produced a significant capital loss, but that loss was taken because I do not expect Ceradyne to recover in the foreseeable future. The profit that we have generated by the sale of calls can be used to offset much of the loss generated by Ceradyne, for our 2009 taxes. Ceradyne was replaced by our purchase of Oracle Corp. By the end of the second quarter, our average cash position was reduced to roughly 13 percent.

TIMING MODEL

The Timing model continued to improve in the second quarter. It moved to a solidly bullish reading of 60%. It predicts a 60% chance of a market recovery and a 40% chance of decline, over the next 3-6 months. It should be noted, however, that after the large rally that we have had over the past four months, it would not be uncommon to have a significant correction (i.e. roughly 10%) over the next month or two.

MARKET OUTLOOK

As I have described in recent reports; the basic foundation for an economic recovery has been put in place. The financial system has been saved and interest rates have been kept at low levels. Thus, corporations have been successfully selling their bonds, and low mortgage rates are slowly allowing the housing market to stabilize. Furthermore, the American automobile industry has made significant progress in restructuring itself for sustainable profitability. Chrysler has been saved (for now), and in recent months, Ford has been gaining market share from its competitors. General Motors is in the final stages of bankruptcy reorganization. Finally, our governments' stimulus program should continue to promote economic growth for another three to six months.

The US (and global) stock market has responded to the above factors by bottoming out in March. Over the last four months the market has recouped roughly one third of the decline generated by this Bear Market. The probability is high, that the Bear Market is over. The big question now is: how long will it take to recover to our previous all – time highs?

The problem with making a reasonable forecast is that none of the previous recessions, with which we have experience, were as deep or long as this one. The severity of this recession will likely produce regulations on the banking system which will reduce the future growth rate. Banks, hedge funds etc. will not be permitted to leverage their capital to the same extent that they did in the past. This will provide a safer financial system but one which will not be able to grow as fast or produce as much profit. The most important change for the future is that the American consumer has lost a great deal of wealth. This recession destroyed housing values, as well as stock and bond values. In addition, unemployment is at 25 year highs and is expected to go somewhat higher. Since consumer spending initiates about two thirds of US GDP growth, it is hard to see how we can spring back as rapidly as we have after past recessions. If I had to guess; I would guess that it would take roughly four years to recover to our previous highs, as opposed to the roughly two years of the past. That still provides the market with a potential yield of 10 – 15 percent per year, over the next four years.

Sincerely yours,

Ray Hofshi

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