



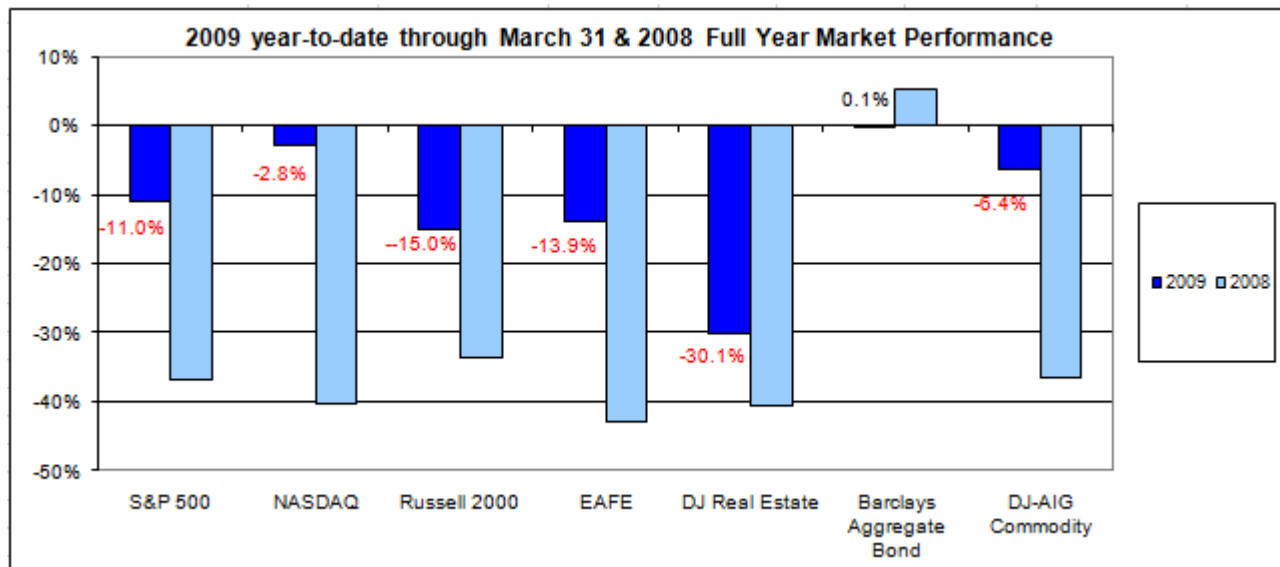
## Markets and Economic Summary & Outlook

March 31, 2009

Global equity markets, with a few exceptions, were down during the first quarter of 2009, but there was some improvement in March and the rebound thus far has extended into April. Historically, since 1950 the equity market started recovering about halfway through each recession, however we remain cautious in what remains a very difficult time for the global and U.S. economies. We should also be cognizant that this time things could play out differently than in the past.

During the first quarter of 2009, the S&P 500, a composite of large and mid-cap U.S. stocks, fell **11%** (total return including dividends), this on top of the **37%** drop in 2008. The NASDAQ Composite by contrast declined a more modest **2.8%** (-40.5% in 2008). Non-U.S. equities, as measured by the MSCI EAFE index, fell **13.9%** during the first quarter (-43.1% in 2008), however several Latin American and Asian markets performed relatively better with Europe responsible for most of the overall decline. Commercial real estate, as measured by REITs (real estate investment trusts), was one of the weaker performers during this quarter, dropping **30.1%** (-40.7% in 2008). Impending trouble in commercial real estate is not good news for the already hard-pressed financial sector (this particularly affects insurance companies).

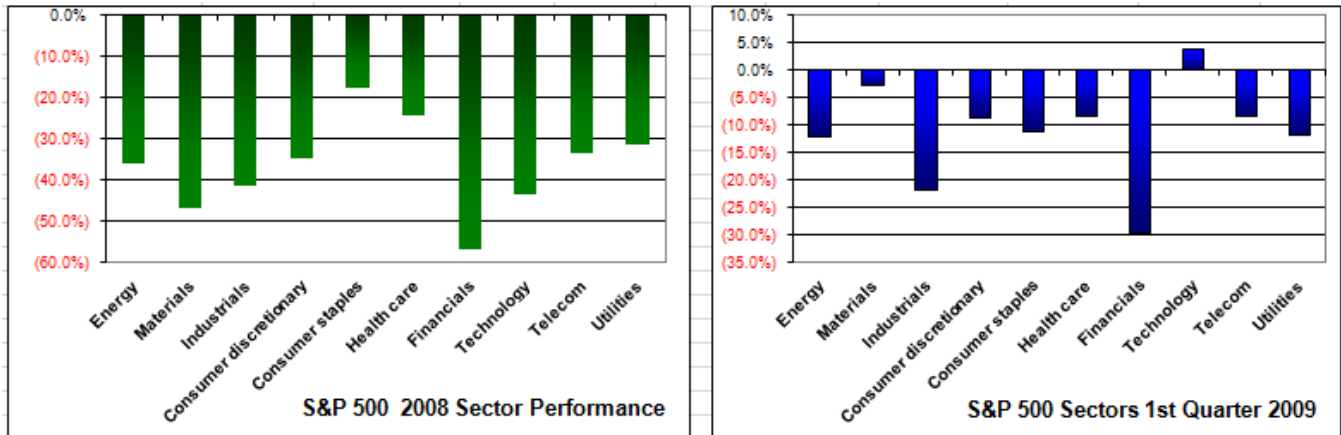
Turning to the bond market, the Barclay's Aggregate Bond Index, comprised of government and highly rated bonds, was up **0.1%** in the first quarter (+5.2 in 2008). The 10-year Treasury yield stood near a still very low 2.7% at quarter-end, partly due to investors' continued flight to quality and actions by the Federal Reserve to maintain low interest rates, which have also helped to keep conventional mortgage rates near historical lows as well. Commodities as a group were down **5.4%** during the first quarter (-36.6% in 2008), primarily due to very large price declines for crude oil and natural gas, which were partially offset by appreciation in gold, silver, and other metals.



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); Barclay's 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 (this index has nothing to do with AIG other than in name).



Within the S&P 500, all industry sectors were down 15% to 55% last year, but thus far in 2009, certain sectors, most notably technology and materials (e.g., mining) have performed considerably better. Technology, now the largest component of the S&P 500 at 18% of the index's total market capitalization, was up 4% for the quarter. It is still unclear if this is a meaningful sign of eventual recovery, but it is encouraging to everyone grown too accustomed to the color red.



Contrary to U.S. equity performance, several non-U.S. markets were up or stable during the first quarter 2009, mainly in South America and Asia. Again, one quarter does not signal a trend, and we emphasize the word caution when drawing conclusions from this brief period of positive market performance. Chinese exports, the principal driver of the economy, are down 25% and Japan's are down 50%. There is little hope that domestic consumption can make up for these declines, therefore the Asian economies could slow well in excess of rosy government projections. China for instance is projecting 7% growth in 2009, but the reality may be closer to 3%, which would lead to much higher unemployment and potential for social unrest.

### Best Performing Non-U.S. Equity Markets

5-year annualized returns

2008 best foreign market returns

Index Name	Return	Related IS
<b>Single Country</b>		
MSCI Brazil Index(SM) (03/31/2009)	+22.38%	
MSCI Chile Investable Market Index (03/31/2009)	+12.49%	
FTSE/Xinhua China 25 Index (04/01/2009)	+11.93%	
MSCI South Africa Index (03/31/2009)	+7.67%	
MSCI Mexico Investable Market Index (03/31/2009)	+6.05%	
MSCI Canada Index (03/31/2009)	+4.11%	
MSCI Israel Capped Investable Market Index (03/31/2009)	+3.77%	
MSCI Spain Index (03/31/2009)	+3.69%	
MSCI Singapore Index (03/31/2009)	+3.59%	
MSCI Malaysia Index (03/31/2009)	+3.25%	
MSCI Australia Index (03/31/2009)	+3.08%	

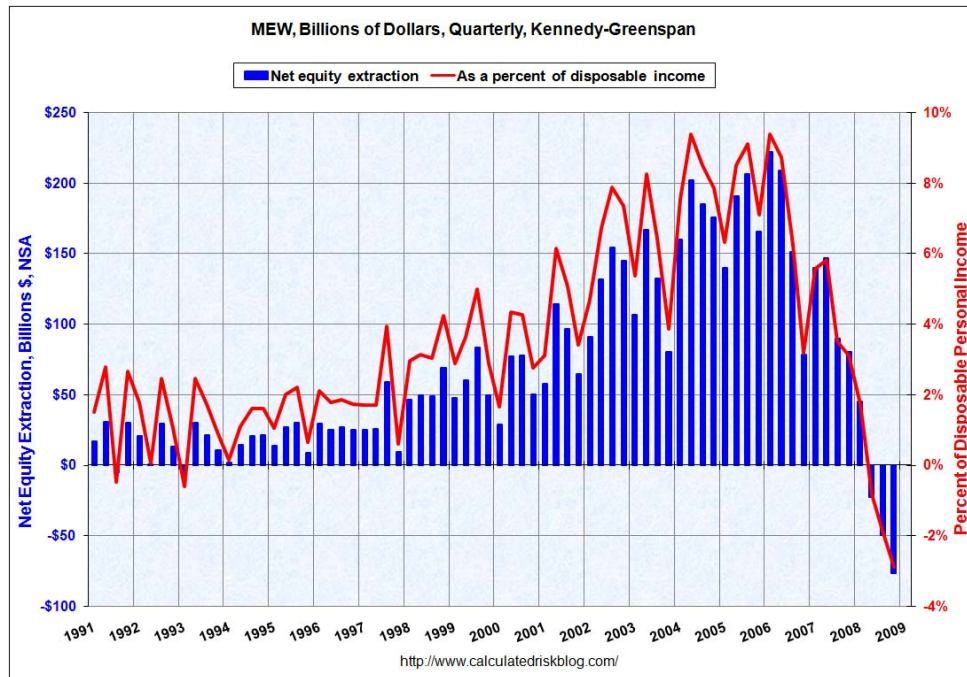
Index Name	Return	Relat
<b>Single Country</b>		
MSCI Chile Investable Market Index (03/31/2009)	+13.63%	
MSCI Brazil Index(SM) (03/31/2009)	+12.45%	
MSCI Taiwan Index(SM) (03/31/2009)	+8.30%	
MSCI Israel Capped Investable Market Index (03/31/2009)	+7.66%	
FTSE China (HK Listed) Index (03/31/2009)	+0.60%	
FTSE/Xinhua China 25 Index (04/01/2009)	+0.48%	
MSCI Korea Index(SM) (03/31/2009)	-0.46%	
MSCI Hong Kong Index (03/31/2009)	-0.47%	
MSCI Australia Index (03/31/2009)	-1.58%	
MSCI Malaysia Index (03/31/2009)	-3.05%	
MSCI Canada Index (03/31/2009)	-3.63%	

Source: Barclay's Global Investors (through March 31, 2009)

## Second Quarter 2009 Outlook

We are now 16 months into the current recession, making this the longest recession since WWII. Unemployment continues to track up and it appears will rise above the federal government's peak 9% forecast. Unemployment in March hit 8.5%, and is near 16% nationally if temporary workers searching for permanent work (underemployed) and those who have stopped looking (discouraged) are included. Unemployment appears to be accelerating and we expect it will rise to 10% as early as this summer.

Overconsumption in the U.S. over the last twenty years was the single greatest cause leading to this recession. Both individuals and governments have run annual deficits, taking the borrowed funds and together with all earned income (e.g., salaries and taxes, respectively) gone off and spent it on stuff. For the consumer, it was a granite countertop in every kitchen, a variation on the old chicken in every pot. Examine the following chart. Americans have been living off home equity and in aggregate have saved very little over the last twenty years, and it's now come home to roost.



Given the current context, consumer spending and sentiment are understandably weak, and industrial production continues to contract. These phenomena have now spread to most other economies, which too have slowed or are contracting. Home prices in the U.S. through January have fallen 28% nationally, and certainly have the potential to drop another 20% should unemployment overshoot the mark and a second and third wave of foreclosures crash ashore as Option ARM and prime borrower defaults accelerate (and they indeed are). We await the results of the Fed's stress tests of the twenty largest banks to see how the disposal of toxic assets and accompanying lack of capital are ultimately resolved, and the financial institutions could get hit by new waves of bad assets, e.g., commercial real estate and credit cards. Some countries, most notably in Eastern Europe, are on the verge of default, which would cause great pain throughout the rest of Europe. Mentioned earlier, the emerging markets have yet to feel the effects of the



slowdown in the U.S. and Europe, and this could send more chills through the global economy. It's possible that the economy doesn't begin expanding again until 2010 and then very slowly at a 1% annual rate for one or two years, assuming a more negative outlook as outlined above.

Looking at a "glass half full" scenario, the economy could get back on track relatively soon, well before it's readily apparent. Remember, the data trails actual events. A coordinated cross-border stimulus, sufficiently large, could catalyze demand and consumption. The bad asset and poorly capitalized bank problems could be dealt with relatively quickly (although these have been drifting). Home prices are likely to drop more this year, but may stabilize when inflation returns and hard assets increase in value to keep up with inflation. People will at some point have to purchase and replace automobiles and other consumer goods. The rate of change in unemployment should slow because industries and services are not expected to completely shut down. Excess capacity should be reduced and right-sized according to global demand, automobile manufacturing immediately comes to mind. Asset and liability valuations should continue to be trimmed downward, but this too will stop at some equilibrium point. All this is painful but it will eventually end, and perhaps the economy may begin expanding by Fall 2009, and may grow 2 to 3% in 2010. This is the federal government's projected expectation.

The equity markets the last several weeks seem to have adopted the latter scenario, however the bond market has hardly budged and, in fact, credit spreads have actually widened, particularly among the financial names. In short, the bond market isn't buying a recovery in the immediate future. Volatility as measured by VIX remains solidly above 40, and in more normal times would hover around 15, signaling the potential for large swings in equities in either direction. It may well be very appropriate therefore to view near-term equity market rallies as suspicious until there's greater clarity on the big problems of the day. This doesn't mean selling all equities, because there is the possibility that we have turned the corner, however, this cannot be determined real-time. The degree of equity exposure is a function of each individual's tolerance for risk and time horizon, which is why we encourage clients to interact with us in determining these factors, as well as review their asset allocation relative to different scenarios.

## **Portfolio Implications for 2009**

- We've tended to focus on dividend paying stocks when evaluating opportunities in equities, but we're living in a world where many companies are reducing dividends to conserve cash. Companies with high dividend payout ratios and debt maturing within the next couple of years tend to fall into this category. It's a particularly good time to review the sustainability of dividend payouts especially should the downturn become more severe or prolonged. On the other hand, there may be opportunities to identify stocks that have been overly punished, while appearing to have sustainable dividend payouts.
- We're very wary of the notion of "de-coupling", where some equity markets (e.g., China) or sectors remain strong while others weaken, just as we're suspicious of projecting future market performance based on the most recent few days or weeks.
- Employment, hours worked, and disposable income continue to trend down, pressuring the consumer, as well as the consumer-oriented industry sectors. Company strength as measured by low debt, diverse revenue streams, good brands and competitive positioning, and strong cash flow have never been more important in identifying companies capable of riding out the storm.



- The ten-year Treasury rose from 2.1% to 2.7% at quarter end, and it appears it may keep rising to attract investors as the Treasury issues massive new debt over the coming months. Most individual investors might best avoid bonds with long-term maturities and low coupons, since these would be most punished when interest rates eventually rise.
- Interest rates will also rise as we return to a more inflationary environment, perhaps less than a year from now. Floating rate bonds and TIPS (Treasury Inflation Protection Securities) might be good candidates to take advantage of this intermediate opportunity. Hard assets, for example, commodities and eventually real estate, should be beneficiaries should inflation heat up as some anticipate.

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