



Markets Summary and Economic Outlook

March 31, 2010

Global equity markets continued to track upward during the first quarter of 2010, with U.S. indices outperforming most foreign markets. An unexpected strengthening of the U.S. dollar in response to sovereign credit issues in southern Europe was partly responsible for this relative outperformance. The continued improvement in several key economic indicators was the main factor driving first quarter results. Job losses in the U.S. did moderate during the quarter, but most economists expect unemployment to remain above 8% over the next two to three years, an unusually high level over a prolonged time period compared to past recoveries since WWII. Consumer spending and retail sales for the first quarter were well above year-end expectations, evidence that consumers' confidence in the economy is in process of repair. Industrial production continued to expand as companies rebuilt inventories (still underway) and to meet a return to year over year sales growth. Aside from these improvements, hazards clearly remain that could challenge sustained growth over the next year. A record number of foreclosures are expected in 2010, some estimates as high as 4 million, and the negative after effect on home prices, combined with still too high unemployment, could impede a more rapid recovery.

The following table summarizes market performance for the first quarter 2010 and full year 2009. The S&P 500, an index comprised of large to mid-size companies, was up 5.4% during the first quarter. The Russell 2000, an index of small cap stocks, rose an impressive 8.9%. The MSCI EAFE Index, a broad composite of non-U.S. stocks, and the MSCI Emerging Markets Index both lagged the S&P 500 during the first quarter. The Dow Jones Real Estate Index, comprised of real estate investment trusts (REITs), was up a 9.3%. Much of the recovery in publicly traded REITs was a story of haves and have nots in commercial real estate. The real estate index is dominated by well capitalized REITs that generally did not participate in large, highly leveraged real estate transactions in the two years leading up to the recession, and several are in very good position to acquire distressed properties at steep discounts.

Total returns for major indexes (1)	2010 first quarter	2009 full year
S&P 500	5.4%	26.5%
NASDAQ composite	5.7%	45.4%
Russell 2000	8.9%	27.2%
MSCI EAFE	0.9%	32.5%
MSCI Emerging Markets	2.4%	79.0%
DJ Real Estate	9.3%	30.8%
Barclays Aggregate Bond	1.8%	5.9%
DJ-UBS Commodity	-5.0%	18.7%

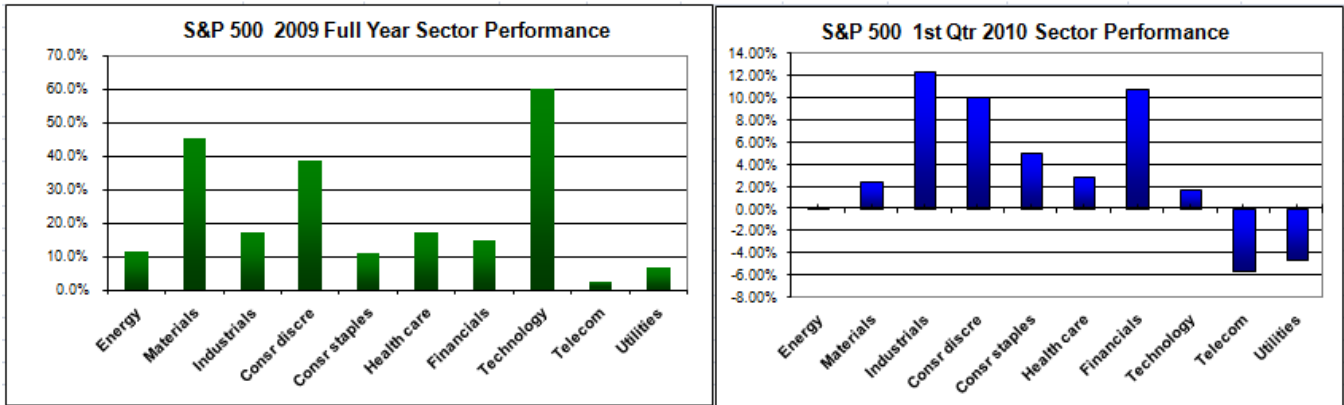
Bonds were up slightly as measured by the Barclays Aggregate Bond Index. The 10-year Treasury finished the quarter at 3.84%, about where it started back in January. Rising interest rates could be an important theme in 2010, and could very well pressure total returns on bonds over the next several quarters. Commodities in aggregate posted an unusual decline relative to equities, primarily due to sharply lower prices for natural gas, corn, wheat, and soybeans.

Within the S&P 500, first quarter performance among industry sectors was scattered as seen in the lower right chart (next page). Industrials, consumer

discretionary, and the financials did very well and were the main drivers in the S&P 500's total return for the first quarter, while the other sectors were up only modestly, or down, as was the case for the telecom and utilities sectors. Industrials benefited from the inventory rebuild underway, as well as stronger sales, much of which is being driven by exports to other countries.



The financials did well given the consensus expectation for lower levels of non-performing assets and charge-offs by most of the banking sector by year end.



The emerging markets took a breather from the torrid performance of 2009. There were few countries topping the U.S. during the first quarter. Japanese equities were among the first quarter's best performing non-U.S. markets, and the yen/U.S.\$ exchange rate was largely unchanged over the period, indicating that currency played little role in Japan's equity performance.

Best performing foreign equities 5-year annualized			YTD through 3/31/2010		
Index Name	Return▼	Related	Index Name	Return▼	Re
Single Country			Single Country		
MSCI Brazil Index(SM) (03/31/2010)	+31.18%		MSCI Thailand Investable Market Index (03/31/2010)	+12.61%	
FTSE/Xinhua China 25 Index (04/01/2010)	+20.96%		MSCI Malaysia Index (03/31/2010)	+9.07%	
MSCI Malaysia Index (03/31/2010)	+15.65%		MSCI Israel Capped Investable Market Index (03/31/2010)	+8.89%	
MSCI South Africa Index (03/31/2010)	+15.10%		MSCI Japan Small Cap Index (03/31/2010)	+8.83%	
MSCI Israel Capped Investable Market Index (03/31/2010)	+14.91%		MSCI Japan Index(SM) (03/31/2010)	+8.18%	
MSCI Singapore Index (03/31/2010)	+13.82%		MSCI Mexico Investable Market Index (03/31/2010)	+8.01%	
MSCI Australia Index (03/31/2010)	+11.65%		MSCI Sweden Index (03/31/2010)	+7.58%	
MSCI Canada Index (03/31/2010)	+11.27%		MSCI Canada Index (03/31/2010)	+5.99%	
MSCI Hong Kong Index (03/31/2010)	+10.76%		MSCI Turkey Investable Market Index (03/31/2010)	+4.95%	
MSCI Korea Index(SM) (03/31/2010)	+10.70%		MSCI South Africa Index (03/31/2010)	+4.57%	
MSCI Sweden Index (03/31/2010)	+7.57%		MSCI Australia Index (03/31/2010)	+4.15%	



2010 First Half Outlook

We've already highlighted several positive trends pointing toward recovery from the worst recession since the 1930's, and there are other indicators that suggest the same. For example, net electricity generation was up 1.9% from December 2008 to December 2009. This is the first month since July 2008 that net generation rose compared to the same calendar month in the prior year (Energy Information Agency). The statistics also tell a tale that while most have improved, we are still quite far from a full recovery. A look at some transportation numbers helps to highlight this fact as well as the magnitude of the drop in commerce in late 2008/early 2009:

- U.S. railroad carloads were **up 16.4%** the week ended 4/10/2010 from the comparable week in 2009, but were **down 12%** from the same week in 2008 (American Association of Railroads).
- Intermodal traffic was **up 14.2%** from last year but **down 10.5%** compared with 2008. Compared with the same week in 2009, container volume **increased 18.2%** and trailer volume dipped 4.8%. Compared with the same week in 2008, container volume was **down 2.7%** while trailer volume was **down 38.8%** (AAR).

There are no quick fixes and there's no getting around that that full economic recovery will take two to four years, possibly longer. So what can investors anticipate in the near term? Productivity is very high at the moment, meaning more goods and services can be produced and sold with much less labor and less cost. This partially explains why corporate profits have been so high the last couple of quarters, and this trend should continue over the next couple of quarters as well. For most companies, balance sheets have never looked so good. Cash and short term investments are at record levels and debt to total capital is either very low or very manageable. So we have a near term situation where corporate profits should be very good, and companies have excess cash that eventually can be returned to shareholders in the form of higher dividends and share repurchases. Many companies have already announced dividend hikes and reinstatements of share repurchase plans. These factors point to what should be a positive environment for equities over the near term.

Summary of near term view of the world:

- The Federal Reserve is laying the groundwork for eventually raising short term interest rates, which today are slightly above 0%. This could happen as early as Fall or could happen as late as next Spring, the latter being the case if the risk of inflation remains low and the unemployment rate still hovers around 9%. Interest rates from short to long term maturities will rise in the not too distant future, with short term rates rising at a faster pace.
- The prospect of higher U.S. interest rates and crisis elsewhere (e.g., southern Europe) should help maintain a strong dollar near term. Longer term, and as sovereign debt issues recede, the dollar is more likely to weaken.
- Forward valuations of equities appear very reasonable based on consensus earnings estimates. Consider this example. Assume a company with a share price of \$40 and \$2.50 earnings per share has a current price to earnings ratio of 16, near its historical average. Earnings are expected to grow about 20% in our hypothetical exercise to \$3.00 per share over the next year indicating a price to forward earnings ratio of 13.3 (\$40/\$3). The share price of this company would have to rise to \$48 for the price to earnings ratio to revert to its historical average of 16. This example is not unlike what we're currently seeing with respect to market value of the entire market. The S&P 500 is currently a shade under



1,200, and could rise to 1,350 based on consensus earnings estimates for the next twelve months should the current market P/E ratio remain unchanged. A lot of things can happen in the meantime to cause this scenario to change, but a reasonable case can be made in its favor.

Portfolio Implications 2010

- We continue the mantra from last quarter's market outlook. Equities still appear attractively valued based on forward earnings expectations. We suggested three months ago that investors interested in growth opportunities might consider sectors that underperformed on a relative basis in 2009. Selected regional banks were mentioned as a possibility. Careful selection of banks large and small might continue to do well over the coming quarters. Capital spending for information technology and capital equipment looks to be a good candidate as well, although some companies in the IT space look a little on the expensive side at the moment. More defensive oriented investors in equities might consider both U.S. and non-U.S. high dividend opportunities among utilities, telecoms, consumer staples, and industrials. Utilities and telecoms have been laggards the last several quarters, and a case can be made for a rebound at some point.
- Higher interest rates reduce the market value of bonds. Very few believe that interest rates can remain at these low levels for too much longer. We continue to advocate reducing the average duration of portfolios in order to reduce interest rate risk. 2010 and 2011 could be difficult years for bonds.

In conclusion, 2010 will be a rebuilding year for the economy. Higher than expected growth might be achievable, but it's certainly nothing to count on, so growth at a relatively slow pace is our expectation for the year. Volatility in the equity markets is very low at the moment, which is reassuring. The main thing we're focusing on is corporate earnings the next few quarters, and if all is well in this area, then the markets should respond favorably.

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- (1) 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 the MSCI index of stocks from Europe, Australia, and Far East; Emerg Mkts is the MSCI Emerging Markets Index; 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-UBS Commodity is a total return index of futures contracts on metal, agricultural, and energy commodities. Sources for all returns data include Barclays, Bloomberg, Dow Jones, Russell Investments, Standard & Poor's, and Thomson Reuters.

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