



Markets Summary and Economic Outlook

June 30, 2010

Global equity markets sharply reversed course during the second quarter, with most major market indexes erasing gains earned during the first quarter of 2010. The side effects of potential sovereign defaults in southern Europe, continued high unemployment in the U.S., and most importantly, a general expectation for a slowdown in growth the second half of the year, were all factors that helped drive down the markets. The second quarter earnings season now underway has set a more positive tone, contributing to some improvement in sentiment and market performance has improved over first few weeks of the third quarter.

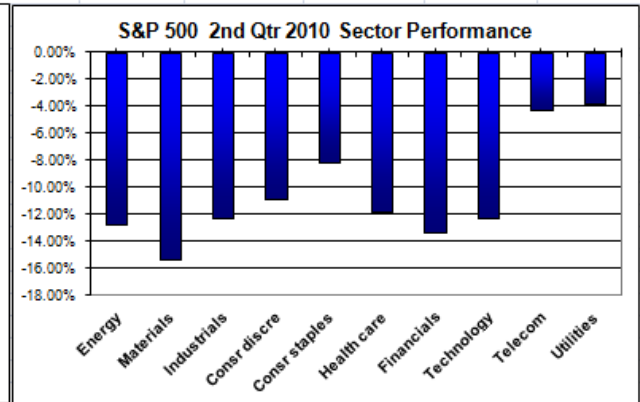
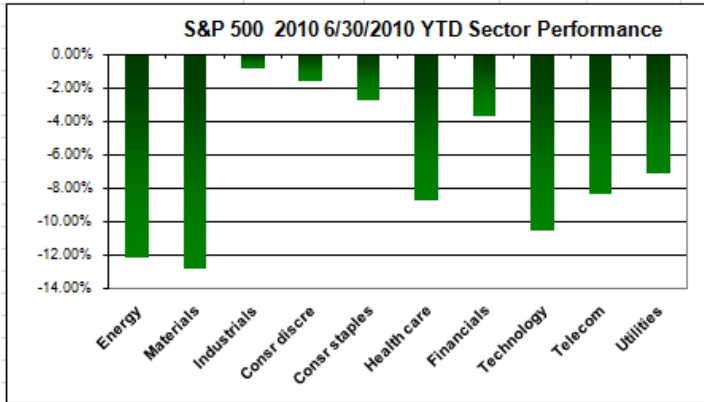
The following table summarizes market performance for the second quarter and year-to-date 2010. The S&P 500, an index comprised of large to mid-size companies, fell **11.4%** during the second quarter. The Russell 2000, an index of U.S. small cap stocks, similarly dropped **9.9%**. The MSCI EAFE Index, a broad composite of non-U.S. stocks, and the MSCI Emerging Markets Index reflected the state of most global equity markets, and were down **14.0%** and **8.4%**, respectively for the quarter. The Dow Jones Real Estate Index, comprised of real estate investment trusts (REITs), was down **4.4%**, but still managed a gain year-to-date through June 30.

Total returns for major indexes (1)	2010 second quarter	2010 YTD through 6/30/10
S&P 500	-11.4%	-6.7%
NASDAQ composite	-11.8%	-6.6%
Russell 2000	-9.9%	-2.0%
MSCI EAFE	-14.0%	-13.2%
MSCI Emerging Markets	-8.4%	-6.2%
DJ Real Estate	-4.4%	4.7%
Barclays Aggregate Bond	3.5%	5.3%
DJ-UBS Commodity	-4.8%	-9.6%

Bonds in contrast to the dismal equity markets performed exceptionally well as investors sought safety. The Barclays Aggregate Bond Index, comprised of Treasuries, agency, investment grade corporate bonds, rose **3.5%** during the second quarter. The 10-year Treasury finished the second quarter under 3%, about 1.5% lower than we expected when the year began. The rising tide of bad news helped to drive most bond yields downward, particularly for U.S. Treasuries as many investors, both domestic and foreign, chose a flight to quality. Sustained weak employment numbers, apparent slowing economic growth, and the risk of deflation could keep interest rates low for several more quarters.

Commodities, expressed in U.S. dollars, generally declined, led downward by energy and industrial metals, such as copper. Gold and silver were among the few commodities to post gains during the second quarter, again as investors sought safe havens from equities.

All S&P 500 industry sectors were down year-to-date through June 30 (left graph next page), with energy, materials, technology, and interestingly, healthcare registering the largest declines through mid-year. Intuitively, one might assume that healthcare as a sector somewhat immune from perceptions affecting the overall economy, but that clearly has not been the case so far this year. There were no winners among sector groups during the second quarter (right graph next page). Telecom and utilities performed relatively better, but these two were the only sectors that registered losses during the 2010 first quarter. Other sector groups were down in excess of 8% during the second quarter, indicative of the lack of any bright spots in equity performance.



Turning to the situation outside the U.S., the few positive performers tended to be concentrated in thinly traded markets, making it difficult to draw meaningful conclusions about relative performance in the international equities markets. Most international markets were down 10% or more at June 30, indicating that global equities have become increasingly correlated, perhaps throwing the once believed diversification benefit for international investing (*temporarily?*) out the window. The worst performing markets not surprisingly were found in Europe, where French, Spanish, Italian, and Irish equities down 20% or more during the quarter.

Best performing foreign equities 5-year annualized			YTD through 6/30/2010		
Index Name	Return▼	Related	Index Name	Return▼	
Single Country			Single Country		
MSCI Brazil Index(SM) (06/30/2010)	+25.15%		MSCI Indonesia Investable Market Index (06/30/2010)	+14.21%	
FTSE/Xinhua China 25 Index (06/30/2010)	+18.53%		MSCI Thailand Investable Market Index (06/30/2010)	+12.35%	
MSCI Malaysia Index (06/30/2010)	+15.30%		MSCI Malaysia Index (06/30/2010)	+9.31%	
MSCI Singapore Index (06/30/2010)	+13.13%		MSCI All Peru Capped Index (06/30/2010)	+4.56%	
MSCI South Africa Index (06/30/2010)	+12.84%		MSCI Japan Small Cap Index (06/30/2010)	+4.49%	
MSCI Israel Capped Investable Market Index (06/30/2010)	+10.82%		MSCI Chile Investable Market Index (06/30/2010)	+3.71%	
MSCI Korea Index(SM) (06/30/2010)	+8.95%		MSCI Sweden Index (06/30/2010)	-0.16%	
MSCI Canada Index (06/30/2010)	+8.29%		MSCI Turkey Investable Market Index (06/30/2010)	-0.57%	
MSCI Hong Kong Index (06/30/2010)	+7.75%		MSCI Singapore Index (06/30/2010)	-1.25%	
MSCI Australia Index (06/30/2010)	+6.26%		MSCI Mexico Investable Market Index (06/30/2010)	-1.83%	
MSCI Sweden Index (06/30/2010)	+6.14%		MSCI Japan Index(SM) (06/30/2010)	-2.71%	



2010 Second Half Outlook

Despite the gloom and doom generally felt at mid-year, with some even calling for a double dip recession, there were/are indicators that would speak otherwise. As mentioned above, the second quarter earnings season now underway continues a very positive trend in corporate profits and cash generation seen over the last several quarters. There has been year over year and sequential improvement in industrial production and indeed, consumer spending, which stand in sharp contrast to seeming growing negative sentiment as we headed into the third quarter. We can recall few instances in the past when signals were as mixed as they are today.

The thing we should perhaps most focus on is that the economy continues to grow, albeit perhaps at slower pace than we're accustomed to following a recession. We live in a time (and it could be for a relatively short period of time), when slow growth feels like no growth. Jobs creation, one component of overall growth, might be slow in coming, particularly in the private sector, but a jobs recovery is in fact underway. For example, 83,000 jobs were created in the private sector in June despite the disappearance of 225,000 temporary census jobs (Bureau of Labor Statistics). We must accept that restoration of the roughly 7 million jobs lost in the recession may take years to recover due to a combination of factors that include a mismatch of skills between the un/underemployed and actual job openings, relatively high productivity within the U.S. industrial and service sectors, weakness in the housing sector, and the migration of many jobs offshore. Weak jobs growth and higher savings rates impede large bumps in consumer spending, all part of what some call the "New Normal." (Mohamed El-Erian at PIMCO gets credit for defining the phrase.)

What might the New Normal mean for the markets? One could expect a sustained period of relatively low interest rates, and as long as companies can maintain or even grow margins (revenue minus operating expenses), this would be a positive for equities. The ability to generate a lot of cash will put pressure on management to return some of this cash to shareholders in the form of higher dividends and stock repurchases. Rising dividends in a world of low interest rates translates to higher stock prices all things being equal. Unfortunately, some of the rules that affect this outcome may be changing. Bush-era tax cuts like the 15% federal tax rate on qualifying corporate dividends are set to expire at year-end. The tax rate on dividends could rise as high as 39% if allowed to lapse by Congress. A jump this large seems does not appear to have much support, and the dividends tax rate is more likely to increase to 20%, although it should be emphasized this is not a sure thing.

Inflation/deflation is one data point we're very concerned about as we head into the second half of the year. A severe slowdown or a contraction, the feared double dip, could lead to a prolonged bout of deflation, which absolutely would not be good for asset values. Major stores of wealth like home value and equity holdings could take a leg down within the deflation scenario, and although the probability of a meaningful period of deflation remains remote, it's something that we maintain on our radar screen. Price stability, and even better, a sustainable mild inflation, would be to our benefit.

Summary of near term view of the world:

- Earlier in the year, we thought the Federal Reserve would see the need to raise the target Fed funds rate as early as this fall. Rather than the recovery gaining momentum, economic growth in the U.S. is now expected to fall from 4% to around 2% over the next couple of quarters as the effects of fiscal stimulus wane. Short term interest rates are close to 0%



right now, and it's probable this low interest rate regime will extend into 2011, or longer, given expectations for little in the way of inflationary pressure and modest growth.

- The recent flight to quality that drove U.S. interest rates lower, also caused the dollar to strengthen, again, contrary to our expectations at the beginning of the year. We still maintain this expectation, but recognize any real weakening of the dollar likely will be pushed back to 2011 or as long as it takes to resolve the European sovereign debt situation to the markets' satisfaction.
- Putting all other factors aside that affect valuations for the moment, a strong case could be made for equities appearing very compelling over the next couple of years. The S&P 500's estimated P/E ratio looking out one year is a low 14 by historic standards (source: Bloomberg). Of course, it's to be seen whether the composite companies can actually achieve their earnings expectations, much of which depends on sentiment and everyone's future spending plans. One could argue the bar has been set low, and from our current vantage point 2011 and 2012 are potentially shaping up to be good years for the equity markets.

Portfolio Implications for second half 2010

- Equities appear attractively valued based on forward earnings expectations, if one assumes the modest (or better) global growth story. Annualized economic growth of around 2% likely translates to expected returns on stocks in the low to single digits for the time being. Index returns out of step with the reality of future economic growth should be viewed with caution in either direction. If equities appear quite cheap, then they probably are cheap by historic standards. This definitely is not a bubbly time we're living in the moment.
- We've long advocated special focus on dividend paying equities, especially those positioned to increase distributions constrained by comfortable coverage ratios, meaning companies aren't borrowing money to pay their dividends. Most income oriented investors, and even individuals looking for growth, should maintain exposure to the dividend paying stock universe. Current dividend payouts look unusually attractive and are out of whack in a positive sense relative to bond yields. Telecoms, utilities, industrials, and master limited partnerships are the first sectors that come to mind for consideration. The one caveat is how Congress will deal with the expiration of the Bush tax cuts.
- We'd also be very interested in any stocks that trade down significantly on short-term bad news, but fundamentally appear much stronger on a long-term basis. There could be several special opportunities in these especially touchy times.
- We still believe that it's in most investors' best interest to reduce the average duration of fixed income portfolios in order to minimize interest rate risk. Growth and inflation expectations are more likely than not to surprise on the upside, which would be to the detriment of bond returns should interest rates correspondingly rise. Expected returns for most bonds fall in the low single digit category given where interest rates are today. High yield bonds also could have special attraction as we're still in an early recovery phase, and generally have relatively short durations while offering relatively large coupon payments.

The economy continues to rebuild and grow at modest pace. Dramatic improvements on the jobs front and consumer sentiment appear unlikely, so we'd best be served adjusting to a slow, *but not no*, growth scenario. Modest economic growth in tandem with meandering improvement on jobs, along with our view that corporate earnings will remain strong, excludes us from the double dip



recession camp. Not that it couldn't happen, it's just very unlikely to occur in our view (always subject to change). We will continue to focus on corporate earnings the next few quarters (so far, so good), and maintain our expectation for respectable, but not eye popping equities performance over the next couple of years.

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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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