



## Markets Summary and Economic Outlook

September 30, 2009

Global equity markets continued to charge upward during the third quarter of 2009, posting returns very similar to the second quarter. The U.S. equity market, it appears, firmly believes the recession ended this quarter, and the economy is back on a growth track. We've seen improvement the last three months in industrial production, new orders for durable goods, and even retail sales. Median home prices too have improved nationally, and actually increased in June and July, the first increases in three years. The equity markets also seem to be anticipating that corporate earnings could quickly recover in 2010 (more on this later), which would be very favorable to stock prices. Recovery for the overall economy, however, could play out quite differently than in past recessions where we'd normally experience 5% to 6% growth in the early recovery phase, typically led by large increases in consumer spending. The consensus view on growth now expects something more in 2% to 3% range. Unemployment could remain elevated for a lengthy period of time, prompting many consumers to remain cautious on spending. It's worth noting that consensus forecasts are often/usually wrong, so it is very possible that the early recovery growth rate could end up well above the low range.

The following table illustrates year-to-date and third quarter market performance. Emerging markets performed exceptionally well through September, but are still down approximately 30% from their highs in 2007. EAFE, a global index of non-U.S. stocks, performed relatively better as well, and some of this is attributable to a weaker U.S. dollar. The U.S. dollar has fallen 5% relative to the Euro, and much more against other currencies, for example, it's down 26% relative to the Australian dollar. The Dow Jones Real Estate Index, comprised of real estate investment trusts (REITs), staged a surprisingly strong rally during the third quarter (up 32.9%), especially considering a 35% to 40% drop in commercial real estate values, vacancy rates that continue to rise for apartments and offices combined with falling rents. Some argue that commercial real estate is a lagging indicator, and that the stronger, less leveraged REITs are in a good position to acquire properties at near distress prices.

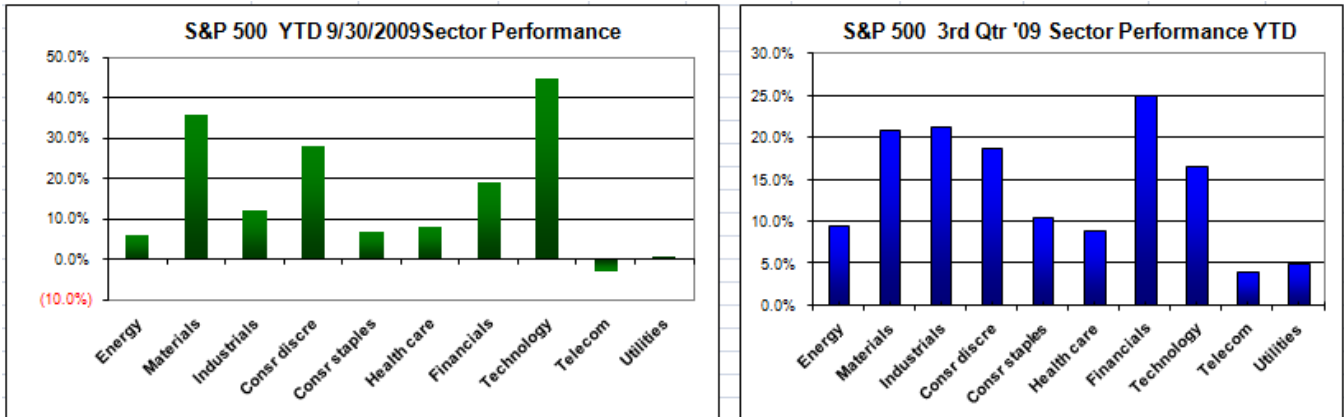
Total returns for major indexes (1)	YTD through 9/30/2009	3rd quarter 2009	2008 full year
S&P 500	19.3%	15.6%	-37.0%
NASDAQ composite	35.6%	15.9%	-40.5%
Russell 2000	22.4%	19.3%	-33.8%
MSCI EAFE	29.0%	19.5%	-43.1%
MSCI Emerging Markets	64.5%	20.9%	-53.5%
DJ Real Estate	20.1%	32.9%	-40.7%
Barclays Aggregate Bond	5.7%	3.7%	5.2%
DJ-UBS Commodity	9.1%	4.3%	-36.6%

U.S. Treasury, agency, and investment grade corporate bonds also rallied during the third quarter, driving the Barclays Aggregate Bond Index up 5.7% through 9/30. A simultaneous rally by both bonds and stocks is unusual, and the bond market appears to believe the Fed will keep short-term rates close to 0% for most of 2010 in light of expected tepid economic growth and low inflation risk for the time being. The 10-year Treasury traded in a very low 3.2% to 3.4% range for

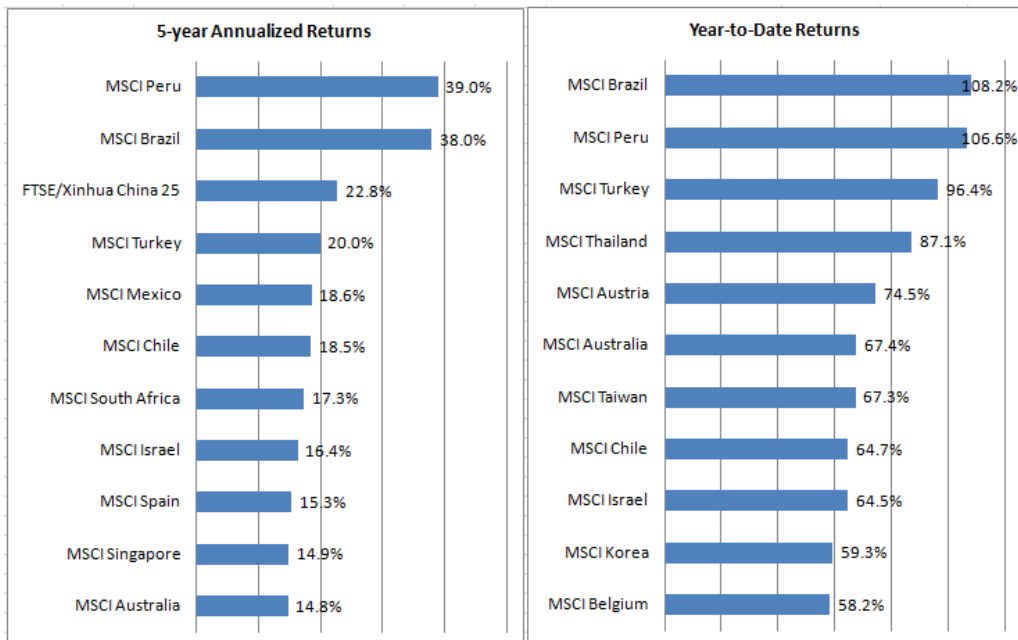
most of the third quarter, which helped the 30-year mortgage rate hover near 5%. For the quarter, commodities were led by metals (e.g., copper up 24%), while most agriculture futures were down (e.g., wheat down 20%).



Within the S&P 500, all industry sectors were up for the second consecutive quarter, led by the financial, industrial, materials (e.g., chemicals & mining), and consumer discretionary (e.g., retail) sectors. Telecom and utilities continued to trail the other industry sectors, and both are flat to down slightly for the year. The rebound in financials is magnified by the low valuation baseline set in 2008.



Many countries' equity markets also had excellent performance this past quarter, particularly among the emerging markets countries. Year-to-date, Brazil (abundant, diverse natural resources), Turkey (15<sup>th</sup> largest economy in the world), Taiwan, and Korea were the best performers. As was the case for Brazil, other resource rich countries performed well including Peru (small equity market but a large copper producer), Chile, and Australia (bottom right table). Going back five years (bottom left table); the equity performance among several emerging markets countries has been quite strong. Contrast those shown on the table with the S&P 500's dismal 1% annualized return. These markets are often more volatile, which also should be taken into consideration. Over the period, thirty-two equity markets around the world outperformed the S&P 500, many coming from the developed world (source: Barclays Global Investors, as of 10/8/09).

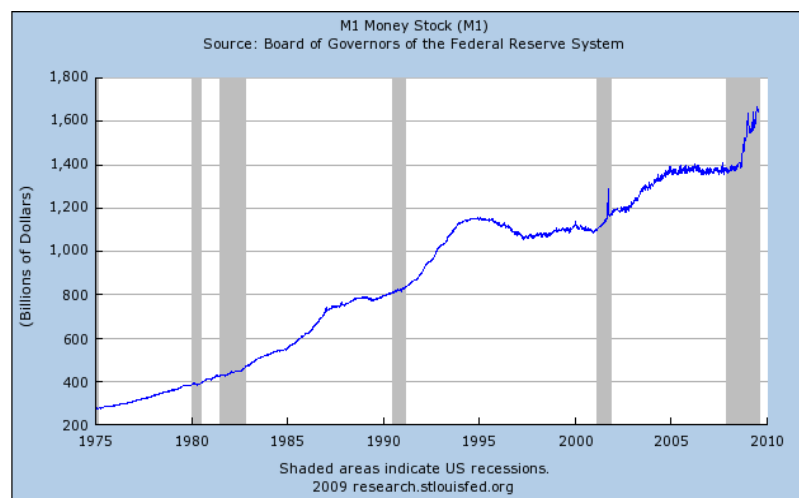


## Early 2010 Outlook

The pace of the recovery in the U.S. is very dependent on the state of the consumer, whose expenditures account for 65% of GDP. Sustained high unemployment, the risk of further job losses, and underwater home values have cast a very dark cloud over consumer sentiment. This combined with higher personal savings and consumers deleveraging by paying down debt leave little available for new spending. There are no quick and easy solutions to high unemployment, which could remain lofty for another two to four years due to a variety of causes including low capacity utilization, high productivity, a now much smaller manufacturing base, and too many individuals with the wrong skill sets (what do construction workers do when new home construction falls over 70%?).

Summary of near term prospects:

- U.S. interest rates are likely to remain very low for at least the next six to nine months. The Fed encourages low interest rates by lowering the Fed funds target rate, which is near 0% at the moment, and by buying securities to make more liquidity available (this is the money printing machine). Normally, these actions would be enough to pull the economy back on its feet, but that's not happening this time, and interest rates cannot go below zero. The low interest rate target also helps to keep mortgage rates down, which is a necessary prop to the housing sector.
- Low U.S. interest rates should lead to a further weakening of the dollar. This has its benefits, primarily in making U.S. goods and services more competitive globally, and trimming the trade deficit a bit. It would also make foreign investors in U.S. securities unhappy when their dollar-based assets devalue. Conversely, dollar-based investors can benefit by owning non-USD securities.
- Inflation is practically non-existent due to large excess capacity, but the money printing machine (see chart below) will bring it back. This may take a year or longer depending on how quickly the economy recovers. Faster recovery portends higher inflation sooner, quickly matched by the Fed raising interest rates and draining liquidity from the system.





- This is not necessarily a doom and gloom scenario, in fact a strong case can be made for rosy equity values. The average P/E ratio in the U.S. has averaged close to 18 the last several years. The next table helps to illustrate this point. The S&P 500's earnings not surprisingly fell sharply in 2008 and should be up a bit in 2009. S&P and others are forecasting a large improvement in earnings in 2010 as companies rebuild inventories, more financial institutions return to profitability, and tech spending picks up steam. The market price of the index migrates up or down to a P/E around 18. At today's index level, the forward P/E is only 14.6. An 18 P/E would imply a market valuation of 1320, about 20% higher than where the S&P 500 is at the moment.

S&P 500 Operating Earnings by Economic Sector: Bottom-Up Estimates as of 10/13/2009

	2007A	% Chg	07 P*/E	2008A	% Chg	08 P*/E	2009E	% Chg	09 P*/E	2010E	% Chg	10 P*/E
S&P 500	82.54	-5.9%	17.79	49.51	-40.0%	18.24	54.88	10.8%	19.56	73.55	34.0%	14.59
S&P 500 Consumer Discretionary	13.31	-15.7%	19.51	5.27	-60.4%	32.12	8.66	64.2%	25.44	13.64	57.6%	16.14
S&P 500 Consumer Staples	15.62	10.1%	19.18	17.18	10.0%	14.36	17.72	3.2%	15.10	19.50	10.0%	13.73
S&P 500 Energy	46.30	6.1%	13.03	50.92	10.0%	7.59	16.89	-66.8%	25.49	31.89	88.8%	13.50
S&P 500 Financials	22.79	-39.4%	17.20	(21.24)	NM	NM	5.20	NM	39.37	11.93	129.6%	17.15
S&P 500 Health Care	23.31	15.9%	17.58	24.48	5.0%	12.64	26.43	8.0%	12.63	29.00	9.7%	11.51
S&P 500 Industrials	21.28	11.8%	16.65	21.18	-0.5%	9.78	14.08	-33.5%	16.51	15.18	7.8%	15.31
S&P 500 Information Technology	17.35	14.7%	23.72	16.13	-7.1%	14.37	15.62	-3.1%	21.86	20.56	31.6%	16.61
S&P 500 Materials	15.97	4.7%	16.27	8.10	-49.3%	17.00	5.34	-34.0%	35.91	10.64	99.2%	18.03
S&P 500 Telecommunications	8.27	3.8%	20.35	8.22	-0.6%	13.59	7.92	-3.6%	13.12	8.12	2.6%	12.79
S&P 500 Utilities	11.67	1.5%	18.53	12.25	5.0%	12.08	11.64	-5.0%	12.77	12.85	10.4%	11.57

Source: Standard & Poor's

- Finally, consumer sentiment should improve as home prices truly stabilize, and this may be occurring as mid-year data appears to show. Sentiment will also improve as it becomes apparent to a greater number of households that things actually are improving, this of course is not the case in the current environment.

## Portfolio Implications for late 2009

- Equities remain attractive in light of valuations (price to earnings and price to cash flow) that still appear very reasonable. Areas of focus include mid and small cap categories, which in past recoveries have performed better than the large caps. Non-U.S. equities also require attention, and this is an area we too are focusing on. The prospect of a weaker dollar adds to the case for owning non-U.S. equities. As always, dividends do matter. We like them for income and reinvestment, and have accounted for 44% of the S&P 500's total return over the last 80 years (source: Standard & Poor's).
- New fixed income investments appear less attractive at this time, particularly as credit spreads have significantly tightened (difference between a bond's yield and a Treasury yield of similar maturity), and overall interest rates remain at historic lows. When interest rates do rise, fixed income securities go down in value. To guard against this we advocate maintaining a relatively short average maturity in fixed income portfolios. Treasury Inflation Protection Securities (TIPS) are a sub-class that may not bring immediate benefits in the no inflation world we live in, but will so a little further down the road. Bonds still play a role in most individuals' portfolios in reducing volatility and providing income that can be reinvested.



- With respect to commodities, most metals appear very rich following large run ups this year, while some like crude oil, and in particular, natural gas are down year-to-date. Inventory in storage is well above 5-year highs for crude and natural gas, but a cold winter and rising demand as the economy recovers should eat into this excess. A question we'd pose is, if crude oil has traded between \$60 to \$70/barrel during most of the recession, where will it be when greater demand emerges?

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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; Emerging Markets 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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