



## Markets Summary and Economic Outlook

December 31, 2011

Most equity markets rebounded during the fourth quarter of 2011 as the risk of an economic slowdown given the problems in Europe seemed to have subsided for the time being. The news from Europe, however, very much continues to cloud the picture, but several key economic metrics have been moving in the right direction here in the U.S. Industrial production, retail sales, and the employment numbers continue to hold steady or have posted modest year over year improvement. As a consequence, U.S. equities were again globally among the best performing markets in 2011, a year when most non-U.S. equity markets ended in the red, with emerging markets down the most. It was an exceptional year for bonds, in particular U.S. Treasuries, indicative of a flight to quality in the face of heightened risk coming out of Europe.

The table below summarizes the performance of the major market indices for the fourth quarter and full year 2011. The S&P 500, an index comprised of large and mid-size companies rose **11.8%** during the fourth quarter, partially erasing the third quarter's **-13.9%** decline. The S&P 500 ended the year up a very modest **2.1%**, and all of this gain was attributable to dividend income. Without dividends the S&P 500's return for the year was zero. The NASDAQ Composite, heavily weighted in technology stocks, rose **8.2%** during the quarter, but ended the year down **-0.8%**. The Russell 2000, an index of U.S. small cap stocks, rose **15.5%** during the fourth quarter, but still ended the year down **-4.2%**, indicative of greater price volatility among small cap stocks compared to large caps. The MSCI EAFE Index, a broad composite of non-U.S. stocks, rose a modest **3.4%** for the quarter, and ended the year down **-11.7%**. The MSCI Emerging Markets Index was up **4.4%** for the fourth quarter, and ended the year down **-18.4**. 2011 was an extraordinarily bad year for the emerging markets countries (more on this further down).

The Dow Jones Real Estate Index, comprised of real estate investment trusts (REITs), rebounded very strongly and was up **13.8%** for the quarter, and returned a respectable **6.1%** for the year. At least 2/3 of the year's return was attributable to income from distributions.

Total returns for major indexes (1)	4 <sup>th</sup> Qtr 2011	2011(full year)
S&P 500	<b>11.8%</b>	<b>2.1%</b>
NASDAQ Composite	<b>8.2%</b>	<b>-0.8%</b>
Russell 2000	<b>15.5%</b>	<b>-4.2%</b>
MSCI EAFE	<b>3.4%</b>	<b>-11.7%</b>
MSCI Emerging Markets	<b>4.4%</b>	<b>-18.4%</b>
DJ Real Estate	<b>13.8%</b>	<b>6.1%</b>
Barclays Aggregate Bond	<b>1.1%</b>	<b>7.8%</b>
DJ-UBS Commodity	<b>0.3%</b>	<b>-13.3%</b>

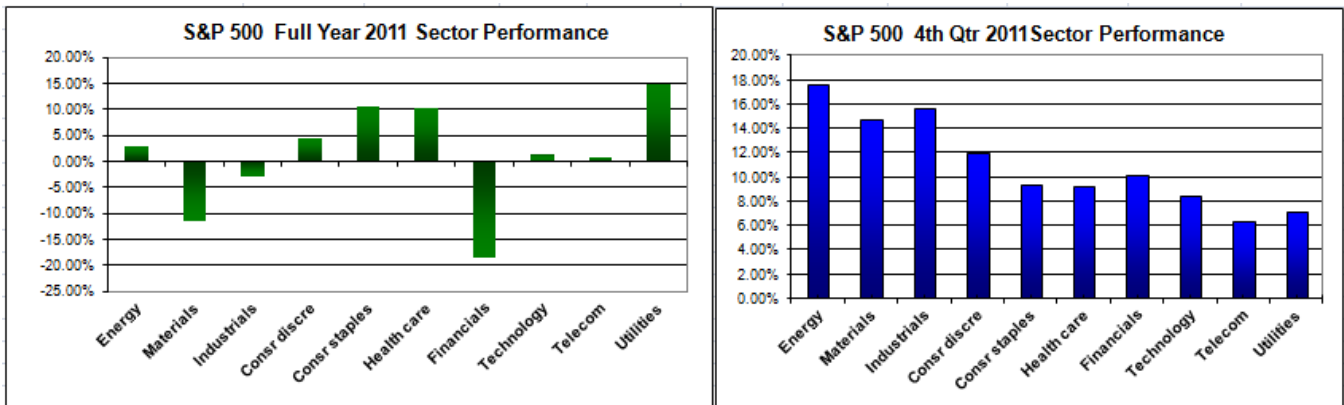
The Barclays Aggregate Bond Index, comprised of Treasuries, agency, and investment-grade corporate bonds, was a big winner in 2011, running contrary to most analysts expectations (including ours) at the start of the year. The index was up **1.1%** for the fourth quarter, and **7.8%** for the year. Treasury securities in the 10 to 20 year maturity band had returns in excess of 20% for the year, marking a stampede to quality during an uncertain time. The yield on the

10-year Treasury bond hovered near 2% throughout the latter half of the year, about 1% lower than the inflation rate, and there is no indication of its rising over near term.

Performance across all industry sectors within the S&P 500 turned sharply upwards (lower left graph). The volatile energy sector, on the heels of the return of \$100 oil, was up nearly 18%, followed closely by the industrial, materials (e.g., chemicals and mining), and consumer



discretionary sectors. Sector performance largely reversed the third quarter's dismal showing owing to the emergence of several positive domestic economic indicators. It was a different story when examining sector performance for the full year however. The financial sector remained sharply down for the year (lower left chart), reflecting concerns about the future profitability within the sector given higher capital requirements. Reduced leverage for most financial institutions translates to lower profits, although many institutions are coming off such low bases that we could see significant short term rebounds in bank stocks (and the potential retreat of prices as well). The utilities, health care, and consumer staples sectors, generally comprised of less volatile stocks, were by far the best performing within the U.S. this past year. This is consistent with our own research that shows that the lowest volatility stocks perform considerably better during periods of high market volatility such as the third quarter of 2011.



Already mentioned, it was an absolutely dreadful year for the emerging markets. The best performing global equity markets are listed on the rightmost table below. The U.S. Minimum Volatility Index was by far the best performing index in 2011, consistent with our previous comment. There were few winners, other than the U.S. in 2011 as the table can attest.

Best performing foreign equities 5-year annualized			YTD through 12/31/2011		
Index Name	Return		Index Name	Return	
<b>Single Country</b>			<b>Single Country</b>		
MSCI Malaysia Index (01/03/2012)	+11.86%		MSCI USA Minimum Volatility Index	+12.87%	
MSCI Brazil Index(SM) (01/03/2012)	+9.44%		MSCI Indonesia Investable Market Index	+4.31%	
MSCI South Africa Index (01/03/2012)	+6.16%		MSCI USA Index	+1.99%	
MSCI Canada Index (01/03/2012)	+4.06%		MSCI New Zealand Investable Market Index	+1.12%	
MSCI Singapore Index (01/03/2012)	+3.54%		MSCI Malaysia Index	+0.12%	
MSCI Korea Index(SM) (01/03/2012)	+3.34%		MSCI United Kingdom Index	-2.56%	
MSCI Australia Index (01/03/2012)	+3.04%		MSCI Philippines Investable Market Index	-2.89%	
MSCI Hong Kong Index (01/03/2012)	+2.78%		MSCI Thailand Investable Market Index	-3.48%	
MSCI China Index (01/03/2012)	+2.24%		MSCI Ireland Investable Market 25 / 50 Index	-3.69%	
FTSE China 25 Index (01/04/2012)	+1.07%		MSCI Switzerland Index	-6.77%	
MSCI USA Index (01/03/2012)	+0.28%		MSCI Australia Index	-10.95%	



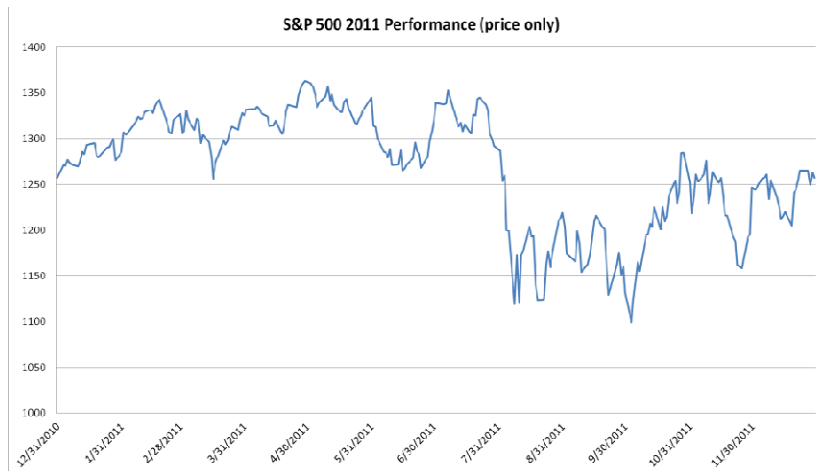
It might surprise the casual observer which equity markets performed the worst over the last twelve months, a group dominated by China, Brazil and a couple of countries caught up in the Eurozone melee, notably Austria and Italy. The Shanghai A Share Index is still down 60% from its peak in late 2007. Concern about slowing growth and rising bad debt within its banking sector are just two of the anchors weighing on China, and there is little reason for near term optimism. The notion of investing in the BRIC countries (Brazil, Russia, India, China) because of never ending, higher growth rates may be irreparably flawed for the time being.

Worst performing foreign equities 5-year annualized		Worst YTD through 12/31/2011	
Index Name	Return▼	Index Name	Return▼
MSCI China Index (01/03/2012)	+2.24%	MSCI All Peru Capped Index	-20.52%
FTSE China 25 Index (01/04/2012)	+1.07%	MSCI Russia 25 / 50 Index	-20.66%
MSCI USA Index (01/03/2012)	+0.28%	MSCI Taiwan Index(SM)	-20.89%
MSCI Taiwan Index(SM) (01/03/2012)	-0.32%	MSCI Brazil Index(SM)	-21.85%
MSCI Switzerland Index (01/03/2012)	-0.71%	MSCI Italy Index	-23.18%
MSCI Sweden Index (01/03/2012)	-0.87%	MSCI Chile Investable Market Index	-23.88%
MSCI United Kingdom Index (01/03/2012)	-2.91%	MSCI Brazil Small Cap Index	-24.09%
MSCI Germany Index (01/03/2012)	-3.39%	MSCI Poland Investable Market Index	-31.17%
MSCI Spain Index (01/03/2012)	-6.16%	MSCI Israel Capped Investable Market Index	-32.11%
MSCI Japan Index(SM) (01/03/2012)	-6.48%	MSCI Austria Investable Market Index	-33.55%
MSCI France Index (01/03/2012)	-7.21%	MSCI Turkey Investable Market Index	-35.91%
MSCI Italy Index (01/03/2012)	-14.74%	MSCI China Small Cap Index	-38.30%

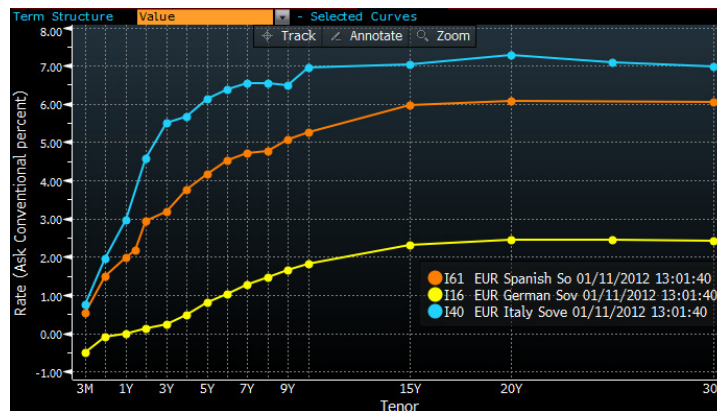
Source: Blackrock

## 2012 Beginning of Year Outlook

2011 was obviously a trying year for the equity markets, more so in the foreign markets. We would expect the first few months to start out in a similar manner. Volatility has diminished since mid-year 2011, but still remains above average. With stocks it's all about investor sentiment and earnings expectations looking out the next six to twelve months. Sudden shifts in news and sentiment can have a profound impact on the markets as the following chart attests. Based on price changes, the S&P 500 ended the year exactly where it started, masking fairly large movements throughout the year over distinct short periods of time, for example, one to three week cycles of rapid ups or downs. We believe that at this moment there are two primary factors affecting investor sentiment and earnings expectations: 1) the European sovereign debt crisis, and 2) the state of the U.S. housing market.

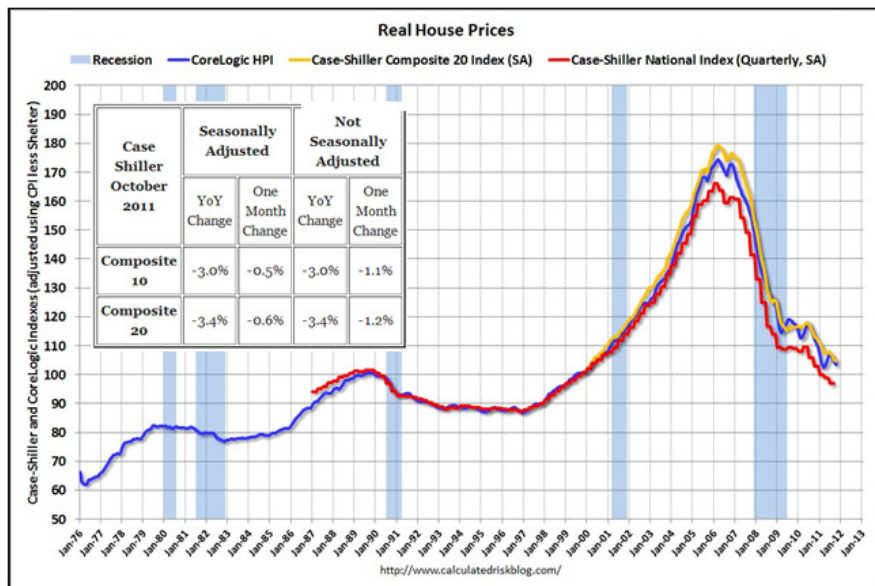


With respect to the first issue, a meaningful, more permanent solution to the sovereign debt crisis has yet to surface. Yields on Italian and Spanish government bonds remain well in excess of those of more healthy countries such as Germany. This manifests massive mistrust within the credit markets. Banks are unwilling to lend to one another, therefore the European Central Bank (ECB) has stepped in to provide near term liquidity. The European banks, major holders of southern European debt, remain severely undercapitalized, and the economies of most European countries have slowed, and it appears some have slipped into recession.



Europe accounts for about 15% of U.S. exports, mainly capital goods such as aircraft and technology equipment or software, so the effect here in the U.S. may be muted. Europe on the other hand accounts for roughly 40% of China’s exports, and clearly the effect is felt more so there. This is a big problem, and one that requires some serious bullet biting, which we think will come to pass, possibly quite soon, to avert disaster. Our first working assumption for the New Year is that a meaningful structure will be cobbled together with all parties making the necessary sacrifices amid the realization that some form of cross border fiscal authority must be put in place for the Euro to survive.

Here in the U.S., the housing market remains the primary problem affecting the domestic economy. As the next chart shows, home prices continue to fall. National home prices declined 3% year over year in October based on the latest S&P Case-Shiller report. A decline in home prices reduces household wealth, which clearly negatively affects consumer sentiment. It also leads to more underwater homes where mortgage debt exceeds the home value, which also increases the probability of more foreclosures and an increase in shadow inventory, and places even more stress on home prices. This affects home builders, who are reluctant to build in an environment where there’s over supply, and this means no pick up in construction jobs, an area of major job losses in the Great Recession. This is a circular problem, meaning a solution has to be found that will break the cycle. The Fed recently floated several ideas that are receiving serious consideration for getting to grips with the problem (<http://federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf>). We’ll go out on a limb and assume that some of the suggestions come to pass and the floor on home prices is finally found. It had better because, if not, some credible analysts foresee another 20% decline in home prices (we don’t believe to experience this much further downside).



Some meaningful progress on addressing the two leading problems of the day (the Middle East aside), and we’ll put in place a solid foundation for future economic growth, less uncertainty, a return to lower market volatility, and the real potential for positive performance in equities markets, something we have not seen over the last ten years.



## Portfolio Implications for Early 2012

- The fourth quarter earnings season has just kicked off and we expect another good quarter for the most part, but would not be surprised if there were a few significant misses on revenue and earnings over the coming weeks. We're already seeing some slight downward revisions, and market reaction can occasionally be unexpectedly severe. These situations may present interesting opportunities to acquire stakes in high quality companies that we perceive as being temporarily oversold.
- We are maintaining our emphasis on assets with attractive cash yields whether it be stocks or bonds. The vast majority of equity holdings in our portfolios pay dividends, and we expect many cash flush dividend paying companies will increase distributions over the next several quarters, a factor that can also drive future price appreciation. High dividend stocks continue to hold special appeal in an exceedingly low interest rate environment.
- We recently completed an analysis of which stocks performed unusually well (or poorly) in times of heightened market volatility. We looked at large, mid, and small cap stocks during the late 2008 to early 2009 very bear market, and mid-2011 when volatility spiked suddenly. Which stocks did better? Large to mid cap, largely dividend paying stocks from exactly three industry sectors outperformed all others during these two periods: utilities, consumer staples (food, tobacco, brands), and health care (mostly large pharmaceuticals). Returns were higher and the price volatility was significantly lower for this group of stocks. The moral, buy low volatility during periods of high volatility, and by the way, this frequently works during periods of low volatility as well.
- There exists the real possibility that interest rates in the high quality sovereign states, the U.S. included, could go even lower should economic growth stall the first quarter or two in 2012. We're generally averse to buying bonds with negative real returns (rate of inflation is greater than interest received), but credit spreads among non-financial issuers in the BB to BBB range appear very attractive, and occasionally we also come across well priced state and municipal securities for the high tax bracket investor.
- We are averse to adding significant emerging markets exposure for the time being. Problems in some countries, most prominently China (property bubble, bad debt, slower growth), are growing in tenor rather than diminishing. The risks seem to outweigh the reward until current conditions subside.

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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 Blackrock, Bloomberg, Dow Jones, Russell Investments, Standard & Poor's, and Thomson Reuters. Currency return data was obtained from the Federal Reserve.

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