



Second Quarter 2009

## WHAT HAPPENED?

Everything was going so well, until the bubble popped. Housing prices increased at double digit annual rates for over a decade, an unprecedented period of wealth creation for most American's most important asset. The 2000-02 recession only served to support the widely held belief that real estate was the road to financial security. The recession decimated stock portfolios, but real estate went up in value even when tech portfolios got vaporized. Not surprisingly, consumers came to believe that a bigger house was a better asset for retirement than a 401(k). Banks financed the great American dream by packaging mortgages in increasingly complicated structures, which could appeal to every sort of investor around the world. Real estate was considered such a solid investment that the rating agencies stamped AAA on most of the debt and the government implicitly guaranteed the housing agencies. So, what could go wrong?

**Sometime in 2007 it became apparent that something was going very wrong.** Investors began to notice that an alarming number of subprime real estate loans were going into default. This began to cause some problems for the buyers of exotic assets tied to subprime paper, but they were mostly hedge funds and institutions who should have known better. Who cared?

Nobody cared, until we found out that Lehman, Merrill Lynch and Bear Sterns were up to their Armani suit collars in toxic loans. Then we found out that AIG had guaranteed more of these loans than they could ever repay and soon, the world's major banks admitted that they had inflated assets and a mountain of bad loans. Suddenly, nobody was willing to trust anybody and the next thing you knew, the world's financial system was effectively shut down.

## PANIC!

When you wake up one morning and find out that you can't trust your bank, broker or your insurance company, you just might panic. If you've just lost several million in the Lehman bankruptcy and there is a rumor that Merrill Lynch is going down, you just might sell their paper now and find out later if the rumor is true or not. If your stock portfolio goes down 30% in a month and the newspaper says we are on the verge of the next great depression, you might put everything in cash. That's what panics are made of.

Free market capitalism is the best system ever devised to create wealth and efficiently allocate resources, but it needs some rules and every once in a while, it needs some help from the government. We can argue what would have happened if we had handled the crisis differently, but the fact is that governments around the world stepped in and ended the panic of 2008 by backstopping the banks and supporting the capital markets. It wasn't pretty and they didn't get it right the first time, but they did it.

**When a house of cards falls down the question is always how it got so big, not why it fell down.** Why did we think housing prices that had barely kept up with inflation for most of this century could continue to go up at double digit rates? Why did we issue mortgages for condos in Miami to people with no jobs and no assets, when there was already a five year supply of housing on the market? How did we let banks and brokers leverage up to 30 to 1 and why did they think they could get away with it? How did the same executives at Citigroup create massive off-balance sheet, “special investment vehicles” for the bank, at the same time they were paying fines to the government for doing the same thing for Enron? How did all but a handful of financial analysts and the credit rating agencies totally miss the risk these firms were taking?

I ask myself why I spotted the housing bubble in early 2007, but failed to see how the crisis would spread to the stock market? The unique thing about this market crash was that it wasn't preceded by a stock market bubble. The market got swept up in the financial crisis, but it didn't cause it by becoming inflated. Perhaps for that reason, very few people predicted the crash, but that's of little solace to me. I said; “Look, there's a truck coming!” Then I stood there and let it run me over. Next time I might just get out of the road instead of waiting to see what brand of truck is coming at me and how fast it's going. I'll try next time.

## **BOTTOMING**

There is one good thing about panics, they don't last long. You can hold your breath for awhile, but pretty soon you have to either breathe or die. The world decided to live and that led to the next phase of the cycle, the bottoming out process for the economy and world financial markets. In November everything stopped, but eventually there was a base demand that needed to be met, even in a recession. As inventories were drawn down, orders eventually came in for new goods. Not as robust as before the crisis, but better than nothing. Consumers cut back on Christmas spending, but Santa still made his rounds. By May, consumer confidence was increasing.

**Recessions are a series of events, not one big bang. The bottoming process is always uneven as one sector of the economy begins to heal, but another catches the disease.** The government stabilizes the banks, but seems to be getting nowhere with autos. China begins to grow, but Eastern Europe looks like a basket case. The economy and the markets periodically look better, only to disappoint us again. The optimists see every rally as the beginning of the new bull market. The pessimists see every market correction as a sign of worse disasters yet to come.

When the stock market made a new low in March, four months after the old low was made in November, it was a necessary but painful part of the bottoming process. The market was clearly saying that despite the promises from world leaders to address the financial crisis, more needed to be done. The better than 30% market rally over the next two months following the March lows, probably indicates that the market felt that the worst of the financial crisis was over. The fact that the market is still down 35% from where it was a year and a half ago, probably means that the market thinks the recession is far from over. It looks like one problem down and one to go.

There is a fine line between bottoming and recovery, which is only obvious after the fact. At some point the velocity of the decline slows and fear of further losing everything gives way to fear of missing the recovery. The May stock market rally is typical of what historically has happened in the early stages of a recovery.

# RECOVERY

**RECOVERY** Definition: The period after the sky falls, but before we forget that it can ever rain again; an irregular and tepid move upward after a crash; the brief interlude between fear and greed.

The high priests of economics, who are in charge of determining whether or not we are in or out of a recession, didn't tell us we were in this one until almost a year after it started. Eventually, several months after the fact, they will tell us when the recession ended, but in all likelihood that will be over a year after the stock market makes that determination. The next big move in the market should be the anticipation of a worldwide economic recovery.

The fast money is already moving into other investments that will benefit from the recovery. Commodities like oil, copper and paper pulp that are tied to the economy are up dramatically in the last couple of months. The US bond market is saying the same thing. The yield curve and TIPS are anticipating higher interest rates as the economy begins to recover. Most telling of all is the decline in yields on junk bonds while treasury yields have been increasing. That's a clear indication that investors are anticipating an improvement in the economy that will put less pressure on highly leveraged companies.

**Granted, this could all reverse tomorrow, but when that many markets are saying the same thing, you have to listen. They are all saying RECOVERY.** It's a great word, much better than PANIC and much more distinguished than BOTTOMING.

Economic recoveries typically come in many shapes and have several stages. Vs are easy. The economy takes a dive, hits a nice bottom once or twice and goes up as fast as it went down. That is not what we are in now, because this recession is already one of the longest ones on record. The shape of this recession is going to be at best a U, maybe a W, with an outside chance that it's a L. Fortunately, Ls are extremely rare. An L is a recession without end. Countries have L shaped recoveries, but a worldwide L is another way of saying that we will have a long worldwide depression. That's highly unlikely given current government policies and the vitality of world trade. Sorry doom and gloomers, things just aren't that bad.

A W is pretty much out of the question too, given the fact that the economy has been down for some time. A recovery followed by another drop at this point would be more like a UU. A double U is another very unlikely form of recession. Generally recession are cleansing events that allow for a fairly long period of recovery and growth. Once inventories are depleted, weak companies are folded into stronger ones, excess speculation is wrung out of the system and consumers rebuild their balance sheets, growth is likely to continue for some time.

Abby Joseph Cohen of Goldman Sachs says the recovery won't be a letter, it will be "stair shaped," as the economy gradually recovers and confidence is restored in stages. That would be nice. Investors would prefer a gradual economic recovery to an explosive one. Explosive economic recoveries cause dislocations in interest rates, commodity prices and labor markets. **Gradual recoveries are generally more sustainable. The last thing we need is a mania.**

This early in the recovery, our investment strategy shouldn't be terribly affected by what shape the recovery ultimately takes...as long as we have one. We have used the bottoming process to buy the best companies we can find in each industry group as the market has devastated one sector after another. We also bought a few bargain basement items that might not be the best of

the best, but we couldn't resist the prices. The great companies we hope to keep for a very long time. The ones that were just cheap we'll probably sell as they get more expensive.

Our equity strategy has been to add to the most depressed industries when others are selling and anticipate an eventual change in sentiment. We bought financials, consumer cyclical and technology stocks that were declared hopeless in the downturn and our contrarianism has begun to be rewarded.

The best performing groups for the past six months have been Technology (+ 24%), Financials (+24%), Materials (+16%) and Consumer Discretionary stocks (+15%). The worst performing sectors were the save havens; Energy (-6%), Utilities (-6%), and Health Care (-1%). If you followed the crowd and sold all your financials and economically sensitive stocks last year, you probably lost money in the market during the past six months instead of being up 3-5% with the major market averages.

Our object is not to try to beat the market by anticipating (guessing) what next quarter's hot sector will be. It is simply to take advantage of the market's irrational extremes by buying what is mispriced and providing our clients a portfolio that is well diversified and therefore able to participate in the market's recovery, whatever form it takes. This portfolio discipline seems obvious to us, but we marvel at how few managers really practice it.

The important work that will determine how well we participate in the market's recovery has already been done. We didn't panic. We remained invested. We bought more of the financial and cyclical stocks that got hit hardest in the panic, because they are most likely to lead the recovery. We have well diversified portfolios because if the recovery is sharp, we'll need commodity and deep cyclical stocks to ride the explosion in demand. If the recovery is gradual, we'll need some consumer staples and more defensive stocks to give us stable growth.

Later on, we will have some difficult decisions to make. Once the recovery is well underway, we will need to make some important asset allocation decisions. Then we can look back and say: "OK, we had a near death experience with stocks, but we've made most, if not all of it back. Now that we are a few years older, what percentage of the portfolio should be in stocks and what percentage in bonds, so we can sleep at night?"

Depending on what the economic recovery looks like and how the government conducts itself, we may either have to construct a portfolio that defends against inflation or anticipates renewed deflation. Fortunately, we have some time before having to worry about hyper-inflation or a new economic collapse. **Right now, all we have to do is to make sure we fully participate in the recovery.**

## BONDS

The recovery in the corporate bond market has been almost as dramatic as the recovery in the stock market. Some of the debt tied to financial companies has doubled in price over the past few months; even stable credits of major industrial companies are trading up 20-30% from their lows. The general feeling in the corporate bond market is that panic selling has given way to prudent buying and most companies can raise money at reasonable rates again.

The treasury market is quite another matter. The recovery meant the flight to quality trade that buoyed treasury prices has diminished substantially. Long-term interest rates moved up from under three to near four percent even as inflation remained at zero and the economy was

contracting. How much of this was the end to the flight to quality trade and how much an anticipation of the recovery is hard to tell. What is certain is that as the recovery takes hold the threat of higher interest rates becomes more important.

Our opinion is that certain sectors of the short-term corporate bond market still remain attractive, but long-term bonds, that are tied to treasury yields are dangerous because of the threat of higher interest rates. We are not ready to adopt fully inflation protected portfolio while the economy is still in deflation, but we see no reason to buy long-term bonds just to pick up a little yield.

Interest rates have not gone up enough to think of Treasury and high quality bonds as anything much more than a safe harbor in a troubled sea. As the sea calms down, the harbor becomes less attractive, which accounts for much of the recent increase in interest rates.

As usual, we expect that the road to recovery will be bumpy. Nothing in nature or the real economy goes in a straight line. What is important is that the financial world has begun to heal itself and that presents a great opportunity for us to make money regardless of how quickly we recover or where the improvement is felt first.

*We have tested the metal of the world's financial system and the character of investors to their breaking points. The weak have failed. The survivors will emerge stronger and better able to reap the rewards offered by an expanding economy and inexpensive assets. Thank you for the confidence you have shown in us in the face of adversity. We look forward to seeing you rewarded for your perseverance.*

*Bill Matthes*

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