

July 7, 2008

RE: Second Quarter 2008



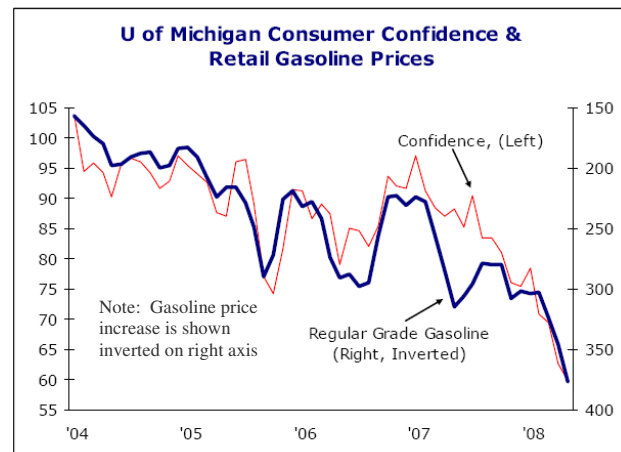
Mark Twain once said "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." During the middle of the second quarter this year, the market was acting as if it knew the worst was behind us, but alas, it appears "it just ain't so." The quarter started out well enough, with the Dow Jones Industrial Average surging over 3% on the first day of April, but ended with the worst month of June since 1970. If the old saying that it's darkest before the dawn is true, then the dawn must be just around the corner because if you watch the news and the market these days, it seems pretty dark. But we are not here to preach doom and gloom. Everyone gets enough of that as evidenced by the lowest consumer confidence numbers in decades. Instead, let's try to peer around that corner and see if we can see any rays of light.

What do we know today? – oil is high, economic growth is slowing and we have an inflation-fixated Frenchman as head of the European Central Bank (Jean-Claude Trichet). The last point may not be as well known to you, but nevertheless, Mr. Trichet's saber-rattling toward the risk of "exploding inflation" has continued to put downward pressure on the dollar and therefore upward pressure on oil (refer to our letter last quarter for a discussion on this relationship). Certainly inflation pressures have increased over the past 12-18 months as many commodities have in fact exploded higher, but with CPI around 4%, it's not as if we need to break out our WIN (Whip Inflation Now) buttons from the 1970s (see chart at right). Quite frankly, we are more concerned about the deflationary pressures of falling home and stock prices. So while we don't mind central bankers talking down inflation, we can only hope that Jean-Claude comes to his senses before he sends Europe into a serious economic downturn.



Source: Bloomberg

We do not want to be Pollyannaish about the current situation. There is no question there are many headwinds facing the market right now and we have been fairly cautious in our investing this year. However, there are a few things we can point to and say maybe things are not as bad as advertised. First, economic growth, while clearly not robust, has been slightly better than expected. As our newsletter highlights, we may get 1.5%-2% GDP growth in the second quarter. Aided by stimulus checks no doubt, but not recessionary. Higher energy prices, while painful, are spurring unprecedented investment in alternative sources of energy and causing some corporations to change their habits in a positive way. As example, Wal-Mart said last month it was going to begin sourcing more produce locally to save on fuel costs – a positive move for local economies and Wal-Mart. Foreign companies are also opening factories in the U.S. to save on



Source: Strategas

transportation costs and take advantage of strong currencies, creating jobs for our economy. Consumers themselves are changing behaviors to be more energy efficient, which will only help us in the long run as we try to become more energy independent. There are no simple solutions and rising gasoline prices have clearly played a major role in depressed consumer sentiment as evidenced in the chart above. The flip side of this picture, though, is any relief in energy costs would probably result in nice bounce in confidence.

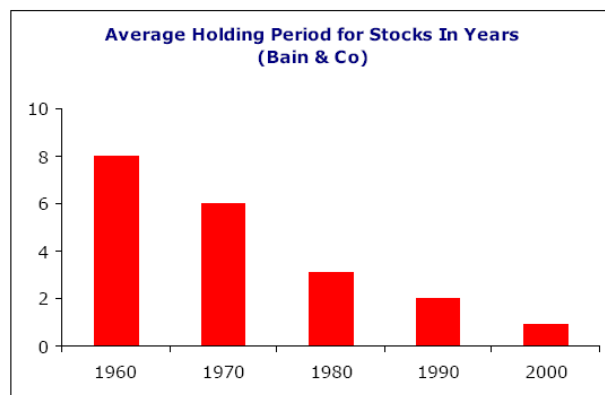
Another area of concern today is the health of the financial system. As we discussed at length last quarter, the problems we are having overall in the market today really started in the financial sector back in the summer of 2007 and our opinion is that in order to move higher on a sustained basis, the problems will have to end there as well. Not that financial stocks have to lead the market, but they at least need to participate. As we look at a chart of the S&P 500 over the past four quarters, the peaks and valley's tend to be associated with various evolutions of the financial crisis; including the latest slide which has corresponded with continuing liquidity issues and write-downs at various financial institutions around the world.



Source: Strategas

As bad as it seems, we have been here before. Remember the S&L crisis in the late 1980s and early 1990s? It was painful, but the market adjusted and corrected and moved forward. We have all had the experience of pulling off a band-aid. If you rip it off, you get a quick sting, but the pain subsides quickly. Currently it feels like we started to yank it but stopped and we have a little bit still hanging on. The financial institutions in this country need to complete the task and pull it completely off for the market to begin to heal itself. We are hopeful this can occur in the coming months.

Finally, we would like to make a comment on market psychology and the extreme volatility we have witnessed over the past six to twelve months. Some of you may have heard of the Efficient Market Hypothesis. Basically this says that prices of securities in the market reflect all available and relevant data and therefore are fairly valued. While we think this theory is probably accurate over the long-term, over the short-term, markets can become very irrational and inefficient as investors react with emotion vs. fundamentals or fact. Witness the tech bubble in 2000, and perhaps oil and other commodities now. These swings in market



Source: Strategas

sentiment have been exacerbated by a more acute focus on short term results and ever-shorter time horizons. The chart above displays this vividly, showing the average holding period for stocks falling from 8 years to around 1 year over the past 40 years. We recognize it is extremely difficult in these types of markets to step back and try to see the forest for the trees, but we continue to focus on doing just that at Greenwood Capital as we continue to endeavor to help our clients navigate this difficult period.

Sincerely,

The Greenwood Capital Investment Team

Philip Bell, Will Bond, Cheves Boyce, Bill Harper, Ashley Sherman, John McAlhany, Michael Nix, Walter Todd and John Wiseman