GREENWOOD CAPITAL Insights

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The Stock Market

The third quarter of 2005 started with a bang and ended with a whimper. The S&P 500 rose over 3.5% in July before posting a loss of -0.1% over the next two months. A moderate pullback in oil, coupled with strong economic news, resulted in the initial gains posted. Unfortunately, hurricanes Katrina and Rita sent oil leaping toward $70/barrel and gas prices over $3.00/gallon in many parts of the country. Given these headwinds, the equity market pulled back nearly 1% in August before trading up slightly in September. The performance in September was somewhat surprising given that it has historically been the worst month for the stock market since 1928. When the gun finally sounded, the S&P 500 index ended up with a total return of 3.6% for the quarter ended September 30, 2005. Year-to-date, the index is up 2.8% on a total return basis.

Market breadth for the third quarter and year-to-date has remained steady with slightly less than half the names in the S&P 500 outperforming the index. While individual stock breadth continues to be fairly widespread, only three economic sectors of the market managed to outperform the index for the quarter. Energy continued its torrid run rising 17.8% for the quarter followed by Utilities (+6.4%) and Technology (+5.8%). Over the year-to-date period, Consumer Staples and Healthcare join Energy and Utilities as the only four sectors that have outpaced the market. Consumer Discretionary (-1.1%) and Telecom (-2.0%) were the worst performing sectors for the quarter and year-to-date periods.

Earnings continue to come in ahead of expectations, posting a 14% gain in the first half of 2005. Upward revisions in the Energy sector continue to push estimates up and it looks as though the S&P 500 may post its third consecutive year of double digit earnings growth. Despite these impressive earnings gains, the index has traded in a fairly narrow range, rising only 10.5% since the beginning of 2004. As a result, valuations (as measured by price-to-earnings or P/E multiples) have contracted. After trading at over 22x earnings in 2004, the market is currently priced at 16.5x, a relatively attractive valuation given the current level of interest rates and inflation. This valuation level coupled with a drop in oil and a foreseeable end to the Federal Reserve tightening could help the market rally in the fourth quarter of 2005. Recent history would suggest such a rally with the S&P averaging approximately 6% in the fourth quarter since 2000.

The Bond Market

As expected, the Federal Open Market Committee (FOMC), the committee within the Federal Reserve System that makes short-term monetary policy decisions, has continued to raise the Fed Fund rates. This action has been driven by their responsibility of helping to manage inflationary pressures through monetary controls. The result has been short-term interest rates increasing four-fold over the last 18 months and more recently long-term rates rising as well. This is typical of a bond market reflecting higher inflation rates, but as the markets anticipate the potential of a slowing economy due to forces such as higher energy prices, we expect rates to remain range bound over the next 6-12 months.

Volatility remains high in the fixed income market and as opportunities present themselves we are moving out of corporate bonds into government obligations due to historically tight credit spreads. While absolute rates are higher than they were this time last year, they are still relatively low. This coupled with a directionally challenged yield environment, will likely result in lower total returns for the fixed income market.

Economic Outlook

The course of the U.S. economy over the next few quarters has been altered by hurricanes Katrina and Rita. Over the long run, however, the overall effect will be minor as the negative consequences of the short run are offset during the rebuilding phase.

Prior to the hurricanes, the economy was growing at a moderate pace of around 3.5% and was expected to continue along this path. Housing and employment growth were fueling the expansion even though energy prices were high and interest rates were being increased by the Federal Reserve.

Katrina and Rita changed our economic expectations. We now anticipate that growth will be weaker over the next couple of quarters. Businesses have been destroyed or damaged and the consumer has been put temporarily out of work. In spite of this, the economy remains resilient and the slow down should be temporary. Rebuilding will create jobs and consumer spending. Government spending at both the state and federal level will also help fuel growth. The federal government alone will spend around $200 billion. Charitable spending will likewise help as some dollars that were going to be saved are gifted and spent.

Looking beyond the volatility due to the hurricanes, the economy is still in good shape. Economic growth may be slower during 2006 than in recent years, but we do not see a recession on the horizon. Higher energy prices will impact spending as households allocate more of their budgets to cover gasoline and heating bills, and higher interest rates will take some of the luster off the housing market which has been a prime driver of our recent growth. The Federal Reserve has increased interest rates eleven times since June 2004. The Prime rate, for example, has risen from 4.00% to 6.75% making it more costly to borrow. Even though rates are higher, they are still low by historical standards and will allow the economy to continue to expand.

Slower growth in an economy is not necessarily all bad. As the economy cools, we should get reduced pressure on inflation which has been moving higher over the past couple of years as energy prices and higher rates have crept into the prices of other goods and services. With less inflation worry, the Federal Reserve will probably terminate the policy of increasing rates in 2006, and the financial markets will begin to look forward to positive economic growth with nominal inflation and steady interest rates. Historically, this has proved to be an excellent time to own financial assets.

In summary, disasters, whether natural or otherwise, can alter the short run performance of the economy, but they do not necessarily change the overall strength over the longer run. The level of interest rates, employment growth, consumer and business spending, and government policy will determine how well the economy performs. Considering all factors, we remain optimistic for the future, especially if we can get some relief from higher energy prices which we expect over the next year.

Market Indicators

(Total Return Through 9/30/05)

	52-Week Change	Changes Since 12/31/04
S&P 500	12.25%	2.77%
DJIA	7.22%	-0.34%
NASDAQ	14.19%	-0.60%
RUSSELL 1000	14.25%	4.06%

Source: Bloomberg