

GREENWOOD

CAPITAL



Insights

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The Stock Market

May 10, 2006. That is the point in time where the second quarter of 2006 went from being pretty good to turning into one investors would just like to forget. The S&P 500 rose over 2.0% through May 9, 2006 before starting a steep decline of over 7% through June 13, 2006. The last two weeks of the quarter provided a little pause in the selling with the market rebounding approximately 2.7% during that time. When it was all said and done, the S&P 500 index closed down -1.9% for the second quarter ended June 30, 2006 (-1.4% including dividends). This marks only the 12th quarter in the past 10 years that the S&P 500 has posted a negative quarterly performance. Year-to-date, the index is still holding on to some of the gains from the first quarter and is up 1.8% (2.7% including dividends).

Market breadth for the third quarter and year-to-date has remained steady with slightly more than half the names in the S&P 500 outperforming the index. On a sector level, performance was fairly widespread, with 8 of the 10 economic sectors outperforming the overall index during the quarter, however only 3 were in positive territory. After being the worst performer in the first quarter, Utilities took the honors in the second quarter as the best performing sector (+4.7%). Energy followed at (+3.8%), with Consumer Staples in third (+2.3%). Healthcare (-5.4%) and Technology (-9.8%) were the worst performing sectors for the quarter and year-to-date period.

As we hinted at in this newsletter after the first quarter of 2006, the Federal Reserve has continued raising rates longer than many anticipated, with the latest increase coming on June 29, 2006. The uncertainty regarding the Fed's ultimate end point and rising inflation expectations have contributed to

the volatility we have seen over the past 6-8 weeks. Until the outlook on the Fed and the economy become clearer, we look for the market to continue to be range bound in the near term. Earnings and valuation continue to be positives for the market. The second quarter looks to be the 12th quarter in a row of double digit earnings increases, with estimates of a rise of approximately 10.4%. Valuation for the S&P 500 remains attractive with a P/E of 14.9x 2007 earnings estimates compared to a median of 17.3x forward earnings estimates over the last five years.

The Bond Market

Yields rose along the curve for the quarter as the Federal Reserve continued its campaign of tightening rates. With the Fed Funds target rate now at 5.25%, the 2 year treasury yield at 5.15%, and the 10 year treasury yield at 5.14%, monetary policy is restrictive. We prefer shorter maturity bonds in this environment. Corporate bond spreads - the amount over treasuries that investors are compensated for assuming company specific "risk" - remain relatively low despite investors reviewing their risk profile over the quarter. We continue to think there is an advantage to waiting until there is more risk priced into this area and generally maintain a lower percentage allocated to this sector.

In terms of performance, "cash" - as determined by the 3 month Treasury bill - has been the best performer through the first six months of 2006. We cannot ignore prospects of a slowing economy, an end to the Fed tightening cycle, and/or investors seeking the safety of US Treasury securities. As such, we will seek opportunities to add exposure to areas that will benefit from these changes.

Economic Outlook

Economic interest during the second quarter of 2006 seems to have shifted from a concern about the economy to a concern about inflation. At their meeting on June 29th the Federal Open Market Committee (Fed) elected to continue raising interest rates mainly using the recent up-tick in inflation data as their primary guide. By increasing the Federal Funds Rate by 25 basis points to 5.25% they hope to head off what they perceive as potential troubling inflation.

As measured by the Consumer Price Index (CPI), excluding the volatile food and energy components, core inflation has increased by 2.4% over the past year, above the comfort level of the Fed. The main culprit behind this rise has been housing, not energy. Owner's Equivalent Rent (OER), which is used to measure housing inflation, accounts for 30% of the core CPI and if you include apartment rent it is 40%. This component has been rising lately due to the lag effect of higher interest rates. Homeownership has become less attractive, and this in turn has lifted the demand for apartments causing rental rates to rise and consequently the OER. If we exclude housing from the CPI, core inflation would have increased by only 1.9% over the past year, not a cause for alarm. Even though we are confident that the Fed understands the effect of housing on the CPI, they are first and foremost inflation fighters, and they would rather err on the side of raising rates too high rather than risk the problems associated with engrained inflation.

Whether we suffer an inflation problem in the future will depend mainly on labor costs which account for 65 to 70% of the cost of production. Currently labor costs are very restrained, and given that the economy is slowing it should not be a problem in the foreseeable future. Unit labor costs in the non-farm sector have risen by only 0.3% over the past year. Without a more rapid rise, an inflation cycle cannot be sustained.

The economy is growing but it is slowing. Less rapid growth will allow the Fed to pause and possibly lower rates as we move into 2007. The Index of Leading Economic Indicators fell by 0.6% in May, the third decline in the past six months supporting the conclusion that the economy should slow in the future. The housing market which has been a prime driver of the economy continues to cool as interest rates rise. Existing home sales are down 6.6% since last May, and the inventory of homes for sale has risen dramatically. New home sales and housing starts have also fallen over the past year.

Higher interest rates have also cooled consumer spending. Mortgage equity withdrawals are no longer a good source of cash for the homeowner, and even more important homeowners are having to pay over 8.25% interest on previous withdrawals as compared to 4.0% two years ago. Higher interest rates and higher energy prices are absorbing a greater portion of the discretionary income of the consumer.

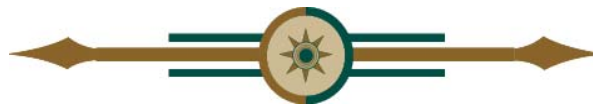
Faced with these and other headwinds, the economy should continue to slow, and without a real threat of sustained inflation, the Fed will stop increasing interest rates at some point in the near future. The Fed does not want to cause a recession which could be the outcome if they overshoot by increasing interest rates too high.

Market Indicators

(Total Return Through 6/30/06)

	52-Week Change	Changes Since 12/31/05
S&P 500	8.63%	2.71%
DJIA	11.09%	5.22%
NASDAQ	6.48%	-1.08%
RUSSELL 1000	9.18%	2.82%
RUSSELL 1000 Growth	6.17%	-0.88 %

Source: Bloomberg



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