

# GREENWOOD

## CAPITAL

### *Insights*



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### **The Stock Market**

The stock market continues to defy the skeptics. As we write this summary today (October 4), the Dow is reaching new all-time highs. Despite the third quarter being traditionally a rough time for equities, this year the market staged a rally from mid-July through the end of September, with the S&P 500 reaching new 5 ½ year highs as the quarter closed. After trading down nearly 3% in the first two weeks of July, the market appreciated in price over 8% in the subsequent 10 weeks. There were a few pullbacks along the way, but the S&P managed to continue to post higher highs and higher lows throughout the months of August and September. When the quarter finally ended, the S&P 500 index ended up 5.2% for the period ended September 30, 2006 (5.7% including dividends). This marks the best third quarter performance for the S&P 500 since 1997 and the best quarterly performance overall since the fourth quarter of 2004. Year-to-date, the index is up 7.0% (8.5% including dividends).

Market breadth narrowed slightly in the third quarter with less than 45% of the names in the S&P 500 outperforming the index, down from over half in the second quarter. On a sector level, performance was balanced, with 5 of the 10 economic sectors outperforming the overall index during the quarter. After being one of the worst performers in the second quarter, Healthcare took the honors in the third quarter as the best performing sector (+9.8%). Telecom followed at 9.6%, with Technology rebounding from a dismal second quarter to come in third (+8.3%). After being standouts in the first half of the year, Materials (-1.1%) and Energy (-2.1%) were the worst performing sectors for the quarter. However, on a year-to-date basis, Energy remains one of the top performing sectors.

It seems clear now that investors and the stock market believe that the Fed is done raising rates and that the economy, while in a slowing trend, remains healthy enough to maintain job growth and spending for

consumers and earnings growth for corporations. The third quarter should extend the streak of double digit earnings increases to 13, with estimates for a rise of approximately 12%. However, the number 13 may prove to be unlucky for the markets as fourth quarter earnings growth is currently estimated to slow to 7%. The next test for the equity markets will be this transition from double digit earnings growth to a more reasonable level of single digit growth over the coming quarters and year. Valuation remains a positive for the markets, with the S&P 500 trading at a P/E of 15x 2007 earnings estimates.

### **The Bond Market**

In the 2<sup>nd</sup> Quarter *Insights*, we noted that “we cannot ignore the prospects of a slowing economy, an end to the Fed tightening cycle, and/or investors seeking the safety of US Treasury securities.” The Fed chose not to raise interest rates further at its two meetings in the 3<sup>rd</sup> Quarter. This, along with economic data supporting a less robust economic outlook, sparked a rally in the bond market. Ten Year Treasuries rose roughly 5% for the quarter moving the year-to-date total return into positive territory (+1.08%). The yield curve has priced in slower growth and the prospects of the Fed easing interest rates. The curve is inverted from Fed Funds to the 5 year area and is positively sloped from there to the 30 year.

Corporate bonds remained resilient and outperformed Treasuries as volatility has been low. However, we continue to favor Treasuries over corporates as periods following Fed rate increases have historically been challenging for corporate bonds.

The municipal curve is positively sloped and offers value for those seeking tax-exempt interest. Prices should remain firm considering the lack of new issue supply and the demand from maturing issues.

## Economic Outlook

The housing market took center stage from energy prices and inflation as the third quarter of 2006 ended. During August, housing starts fell to an annual rate of 1.67 million units from 1.77 units in July and have declined by almost 20% over the past year. Building permits, a gauge of future construction, also declined in August, and we saw an increase in the inventory of unsold homes as well. Rising mortgage rates and a slowing economy are taking a toll on housing, and a weak housing market has a major effect on the economy, not only because of the loss of home construction, but also due to the decline in the demand for related products and services such as appliances, architects, etc.

Maybe more importantly than home construction, the median price of a previously owned home fell in August, the first yearly decline since April 1995 and the second biggest decline in the survey's 38 year history. The value of one's home is a major component of household wealth and any decline will affect consumer confidence and consumer spending decisions. Much of our recent economic growth has been fueled by the consumer tapping the equity in their home and without rising home prices this source of funds gets capped out. While the consumer may face some headwinds as we move forward, the recent decline in energy prices will provide some relief, and we expect that the consumer will remain resilient and allow for continued economic growth.

The weakness in the economy continued to build during the third quarter as it did during the second, but the threat of a recession appears remote. As measured by Gross Domestic Product (GDP) the economy grew by 2.6% during the second quarter, and growth will likely be in the 2% to 2.5% range for the third quarter and the remainder of the year.

The weakness in the economy along with the lack of any sign of embedded inflation has captured the attention of the Fed. At their meeting in August, the Fed elected not to raise interest rates for the first time in two years. After increasing the Federal Funds rate from 1% in June of 2004 to 5.25% in June of 2006, they held rates steady citing the slowing economy and the lack of core inflation pressures. At their meeting in September they reaffirmed their August decision and acknowledged that the housing market decline was more than gradual and that the risk of energy induced inflation had receded.

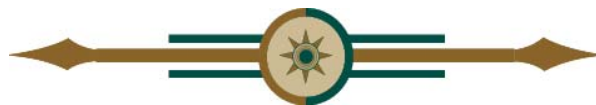
The change by the Fed is important as it would seem to imply that without the risk of labor driven inflation, the next move would be for the Fed to lower rates in order to reduce the risk of a recession. Historically, it has only been 6 months, on average, after the Fed quit raising rates that they begin to lower them. If the economy continues to slow, as we anticipate, it is highly likely that the Fed will begin lowering rates in 2007, maybe earlier rather than later, which should be very positive for the equity markets.

### Market Indicators

(Total Return Through 9/30/06)

	52-Week Change	Changes Since 12/31/05
<b>S&amp;P 500</b>	10.79%	8.53%
<b>DJIA</b>	13.14%	10.85%
<b>NASDAQ</b>	5.84%	3.02%
<b>RUSSELL 1000</b>	10.34%	8.02%
<b>RUSSELL 1000 Growth</b>	6.08%	3.02%

Source: Bloomberg



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