

# GREENWOOD

## CAPITAL

### *Insights*



The Quarterly Publication of Greenwood Capital

(877) 369-5390 (toll free)

[www.greenwoodcapital.com](http://www.greenwoodcapital.com)

January 2007

### **The Stock Market**

The rally in the equity markets that began in the third quarter continued through the end of the year as lower interest rates and lower oil prices helped push stocks higher. The Dow and S&P 500 seemed to hit new multi-year highs on a daily basis during the quarter. With the exception of brief pullbacks in late October and November, the market headed higher for most of the quarter. The S&P 500 posted its best quarterly performance since the fourth quarter of 2004, finishing up 6.2% (6.7% including dividends). For the year, the S&P 500 ended up 13.6% (15.8% including dividends). The Russell 1000 Growth, a major index which we monitor and use for comparative purposes, also posted a solid quarter up 5.6% (5.9% including dividends) and finished the year up 7.8% (9.1% including dividends).

On a sector level, performance was balanced, with 6 of the 10 economic sectors outperforming the overall index during the quarter. Energy, Materials and Consumer Discretionary were the top three performing sectors, all up over 10%. Financials, Telecom and Utilities also beat the index during the quarter. As equities rallied, the more defensive sectors of the market lagged the index, including Healthcare (1.4%) and Consumer Staples (3.5%). For the year 2006, Telecom was the surprise leader, fueled by M&A within the sector. Energy followed in second. Utilities, after lagging in the first half of 2006, staged a comeback to finish as the third best performing sector of the year. Healthcare and Technology were the biggest laggards.

Earnings growth in the third quarter ended up much stronger than expected, growing at over a 20% year-over-year rate. This was the 13<sup>th</sup> consecutive quarter of double digit growth dating back to the third quarter of 2003. However, based on current estimates, the fourth quarter growth is projected at just 8%. While this is still a healthy number, it does represent a significant downshift from the pace of the past several years. One of the keys to the

market's performance in 2007 will be how it digests this slowdown in earnings growth over the next several quarters. Given the strong move in stocks since the summer, the market seems to be anticipating a soft landing in the economy with little disruption from the Federal Reserve's 24-month rate hike campaign and a slowing housing market. While we remain optimistic for 2007, we believe there is some risk in the near-term to the equity markets as economic growth and earnings continue to moderate. As we highlighted last quarter, valuation remains a positive for the markets, with the S&P 500 trading at a P/E multiple of 16x 2007 earnings estimates.

### **The Bond Market**

We are excited about our fixed income performance for the year. Our bias to shorter-dated maturities (0 to 5 years) proved beneficial versus longer-dated maturities (10 to 30 years) on a total return basis for the year. The yield curve was flat-to-inverted for most of the year, yet prices on the front end held steady in the face of increases in the Fed Funds rate through June. Some indications of declining growth, as outlined below in our Economic Outlook section, provided support to bond prices as the 10-year treasury rallied from July to November. In the end, there was not enough economic weakness or inflation containment to prompt a change in the Federal Reserve's stance on current policy.

If conditions warrant the Fed to lower the Funds rate and we continue to see foreign inflows, bonds will perform well in 2007. We are concerned about the lack of risk premium demanded by investors for corporate bonds. Just 4 years ago, corporate spreads (the amount of yield over a comparable treasury) were roughly 3 times what they are today. We continue to forecast an increase in spread and remain underweight to this sector. We have also seen some company specific risk with the recent increase in leveraged buyouts.

## Economic Outlook

“Goldilocks” is probably an appropriate description of the 2006 economy. The economy expanded at a pace that was not fast enough to fuel inflation nor slow enough to invoke a fear of recession; in other words “not too hot and not too cold”.

The economy grew at an annual rate of 2% during the third quarter, and based on preliminary data, especially retail sales, growth will be similar during the fourth quarter. Retail sales were robust during November but appear to have cooled after the reversal of the aggressive discounting of “Black Friday”.

Fourth quarter performance is very dependent upon the Christmas season and sales over this period are hard to predict due to retailer discounting. In addition, gift cards have become popular in recent years and they are not recognized as sales until they are redeemed, mostly in January.

Inflation, another component of a “Goldilocks” economy, appears to be contained. Monthly statistics can be volatile, but the Consumer Price Index (CPI), through November is 2.0% higher than last November and excluding the volatile food and energy components, core inflation is 2.6% higher. Neither measure is a major cause for alarm, especially given the recent decline in energy prices. Oil prices will continue to be volatile but we believe that they will likely fall as more non-OPEC supply becomes available and we pursue alternative sources of energy and focus more on conservation. The labor markets also have room to grow without increasing labor costs excessively.

In light of the nature of the economy, the Federal Reserve (Fed) voted to maintain interest rates at current levels at their December meeting. The Fed may be a little worried about energy induced inflation since they are primarily inflation fighters, but they are also aware of the effect on the economy of the housing market decline and the longer run impact of the 17 consecutive

interest rate increases that they implemented between June 2004 and June 2006. Over this period the Prime Rate rose from 4% to 8.25%. The housing market has suffered a big correction over the past year. Even with the 6.7% rebound in November, housing starts have declined by over 25% and building permits continue to fall. Housing is a major component of the consumer’s wealth and a decline of this magnitude can destroy consumer confidence and spending, cornerstones of our economy. The availability of equity from refinancing homes has been a large source of funds supporting consumer spending and the correction in housing has caused a large drop in Mortgage Equity Withdrawals (MEW). MEW is around \$500 billion less than it was at the beginning of 2006, a huge reduction.

Looking forward, we anticipate that the economy in 2007 will continue to grow at a slow, non-inflationary pace and not enter into a recession. As the economy slows we also expect the Fed to lower interest rates in order to protect the economy from moving closer to a recession. How quickly they lower rates will depend primarily on the behavior of inflation which should not be a problem. If the year materializes as we expect, 2007 could be a very good year to own higher quality financial assets.

### Market Indicators (Total Return Through 12/31/06)

	52-Week Change	Changes Since 12/31/05
<b>RUSSELL 1000 Growth</b>	9.13%	9.13%
<b>S&amp;P 500</b>	15.79%	15.79%
<b>RUSSELL 1000</b>	15.56%	15.56%
<b>DJIA</b>	19.04%	19.04%
<b>NASDAQ</b>	10.39%	10.39%

Source: Bloomberg



This newsletter represents the opinions of Greenwood Capital Associates, LLC and is for informational purposes only. It is not intended as a basis for the implementation of any particular investment strategy or any decision to purchase or sell.