

GREENWOOD

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Insights



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The Stock Market

After its March correction, the equity market continued to climb through April and May, with the S&P 500 rising over 7% during that time period. The S&P 500 set a new five year closing high on June 4, 2007, before pulling back during the remainder of the quarter. Despite falling 1.7% in June, stocks posted very respectable returns for the quarter ending June 30, 2007. For the second quarter of 2007, the S&P 500 finished up 5.81% (6.28% including dividends) while the Russell 1000 Growth index climbed 6.56% (6.85% including dividends). Year-to-date, through June 30, 2007, the S&P 500 is up 6.00% (6.96% including dividends) versus the Russell 1000 Growth index gain of 7.51% (8.12% including dividends).

Private equity and leveraged buyouts continued to act as catalysts for the market overall as did improving earnings and economic prospects around the world. Cyclical sectors continued to perform well, including Technology and Industrials which were the second and third best performers during the quarter. Energy was the best performing sector, driven by gasoline and oil prices which were up 8% and 3%, respectively, during the quarter. Financials and Utilities were the worst performing sectors for the quarter as these interest rate sensitive areas were slowed by rising Treasury yields. In addition to rising rates, continued fears about the sub-prime loan market also contributed to the underperformance in Financials as investors tried to evaluate the exposure firms face to this risky area of the mortgage market. Several hedge funds went under as a result of their exposure to the sub-prime mortgage market and this issue will most likely continue to weigh on Financials for the remainder of the year. For the year-to-date period, Energy, Materials and Telecommunications were the leaders, all up over 15% while Financials and Consumer Discretionary were the laggards, returning -0.8% and 2.9%, respectively, for the six months ended June 30, 2007.

While earnings finally slowed below 10% in the first quarter of 2007, they did come in better than the overly pessimistic analysts' forecasts of 3%-4%. As we head

into the second half of year, the strength of the global economy appears to be keeping the U.S. from slowing significantly. Despite a weak GDP in the first quarter, second quarter growth appears healthy. Steady, if unspectacular, GDP growth of between 2%-3% for the remainder of the year should allow the Federal Reserve to remain on hold and allow stocks to continue to work higher. The wildcard in this scenario is the housing / mortgage market in the U.S. If the weakness in these markets continues to deteriorate and spread to other parts of the economy, growth in GDP and earnings could come in under forecasts.

The Bond Market

Bond market activity in the second quarter was characterized by widening credit spreads due to a rediscovery of risk and higher long term yields as a result of strong global growth. In this environment, our bias for high-grade, short to intermediate bonds benefited us relative to the benchmark.

Lest we forget, there is risk in fixed income investing. The low interest rate environment produced an increased appetite for yield by investors at all levels. Sub-prime mortgages and CDO's (Collateralized Debt Obligations) have moved from the business page to the front page of newspapers due to the weak housing market. As a brief review, roughly 25% of mortgages on new homes in 2006 were sub-prime – those of less creditworthiness. These loans are packaged, divided into "groups" (tranches) with different ratings based on repayment hierarchy, and sold to investors. Investment banks then package the lower tranches into CDO's, establish another hierarchy, and sell these to investors. Rating agencies rate the tranches based on historical default rates, cash flow priority and diversification, yet the underlying component remains sub-prime mortgages. The problem begins if the default rate rises above the assumption – which is happening – and investors are forced to revalue the investment. The key lesson here is to understand your investments!

Global growth during the quarter spawned higher real interest rates. The treasury yield curve has normalized and is upward sloping again diffusing those portending an imminent recession on the basis of an inverted yield curve. Looking forward into the 2nd half of 2007, we see more fallout from the above mentioned sub-prime and CDO issues. We expect rates to grind lower through the end of the year following their historical pattern. The upper point of the 10-year Treasury bond trading range should be the 5.30% level we saw in early June.

Economic Outlook

The economy managed a rebound during the second quarter after a dismal first quarter during which Gross Domestic Product (GDP) grew by only 0.7%. Strength continues to come from the consumer, but the foreign sector is playing a bigger role than it has in the past. Foreign economies are strong and with the weakness of the dollar, exports are growing rapidly. Preliminary estimates indicate that trade will add one percent to GDP in the second quarter. Inventory building is also adding to our growth. Businesses are rebuilding inventories after letting them decline during the softness of the first quarter. Overall growth during the second quarter should be around 3.0%.

The economy may be stronger but there are signs of weakness, with housing being the major concern. Higher interest rates along with higher energy prices are affecting the demand for housing as consumer income is stretched. Existing home sales, new home sales and housing starts all fell during May. In fact, the inventory of unsold existing homes has grown by 23.5% over the past 12 months. Currently, there is an 8.9 month supply of unsold homes, the highest since 1992.

As expected, the housing slowdown has increased mortgage loan defaults. Holders of sub-prime loans are really feeling the pinch. Interest rates on these loans are resetting from the incentive rates of the easy credit housing boom. Sub-prime resets totaled \$25 billion in June after averaging around \$15 billion in previous months. Resets should peak at around \$40 billion per month before they begin to decline in 2008. Sub-prime lenders are suffering losses and investors in funds that hold these lower quality mortgages are losing money.

Over the past two weeks two large hedge funds offered by Bear Stearns have been affected with one closing and the other requiring a large infusion of additional capital. This may be just the beginning.

At the June meeting the Federal Open Market Committee (Fed) elected to hold interest rates steady as they have for the past year. The Fed is concerned with the probability that higher energy prices and stronger world growth could result in an acceleration of inflation. Currently, inflation is not big problem. Through May, the core Consumer Price Index (CPI) is 2.2% higher than last year and the core Personal Consumption Expenditure Price Index 1.9% higher. The Fed would like to keep these rates around 2.0% at a maximum. Even recognizing the potential risk to the economy of a collapse in housing, the Fed would rather err on the side of less inflation. The Fed believes that the housing problem will moderate and the economy will continue to expand without providing any interest rate help at this time.

If, as we expect, the weakness in housing and higher energy prices continue to negatively affect consumer spending, the Fed could still lower interest rates before the end of the year. The Fed is foremost an inflation fighter, but they do not want a recession and will lower rates in order to avoid one if possible. Even without lowering rates, a moderately expanding economy with nominal inflation, like we have, should be positive for the financial markets over the remainder of the year.

Market Indicators

(Total Return Through 6/30/07)

	52-Week Change	Changes Since 12/31/06
S&P 500	20.59%	6.96%
DJIA	23.04%	8.75%
NASDAQ	20.72%	8.17%
RUSSELL 1000	20.48%	7.20%
RUSSELL 1000 Growth	19.04%	8.12%

Source: Bloomberg



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