

GREENWOOD

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Insights



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The Stock Market

If you were not able to get to the theme park this quarter to ride the rollercoaster, all you needed to do was watch the stock market over the past three months. After climbing to new all time highs during the first three weeks of the quarter (on July 19, 2007 to be exact), the market took a tumble and headed almost straight down through mid August. That's when the Fed started its rescue operation (more on this later). When the quarterly ride ended on September 30, 2007, the S&P 500 finished just about where it started on June 30, 2007. Officially the index finished up slightly for the quarter, 1.6% (2.0% including dividends) while the Russell 1000 Growth index climbed 3.9% (4.2% including dividends). For the year so far, despite all the ups and downs of the past several months, the equity markets have managed very respectable returns. Year-to-date through September 30, 2007, the S&P 500 is up 7.7% (9.1% including dividends) versus the Russell 1000 Growth index gain of 11.7% (12.7% including dividends).

Sector returns during the quarter were not what you would expect given the talk of a significant U.S. economic slowdown. Cyclical sectors continued to perform well, driven by growth outside the U.S. and a weakening dollar. Energy again took the top spot for the second quarter in a row, driven by oil prices that reached record highs in September. Technology and Industrials repeated from the second quarter as the second and third best performers. As in the first half of the year, Financials performed poorly as concerns about balance sheet risk related to housing and sub-prime mortgages remained prevalent. Consumer Discretionary stocks were the worst performing for the quarter with retailers of all different shapes and sizes reporting slower sales during the period. For the year-to-date period, Energy, Materials and Telecommunications were the leaders, all up over 17% while Consumer Discretionary and Financials were the laggards, returning -3.6% and -5.0% respectively for the nine months ended September 30, 2007.

What looked to be shaping up as one of the worst quarters in years back in mid August was turned around

by the Fed when they lowered the Discount Rate on August 17 and then the Fed Funds rate on September 18. In our stock market summary last quarter, we highlighted the spread of housing weakness as a risk to the economy. This risk appears to be becoming a reality today and the Fed is reacting to try and ease the pain to the broader economy. The Fed's actions have worked in the short term to relieve some stresses in the financial markets. Global growth appears to be withstanding the U.S. slowdown so far, but it is probably too early to give the all clear sign yet. The upcoming earnings season should be interesting, especially for the financial stocks, as investors discover the extent of the damage done by the housing and mortgage market. October could be a bumpy month as investors digest these earning reports and await the next Fed meeting at the end of the month. Both the domestic jobs market and international growth remain keys for the stock market to move higher in the months ahead and we will be watching both of these areas very carefully.

The Bond Market

What a quarter for the credit markets! Federal Reserve governors offered tough talk on inflation before and after a risk revaluation, but in the end responded with two easings in the Discount Rate and a 50 basis point cut in the Federal Funds Rate. There is more detail on this in the Economic Outlook section.

In last quarter's report, we discussed issues surrounding the sub-prime and securitized debt markets. There is plenty of fault to go around – issuers, rating agencies, etc. – yet the end result was a chink in the armor of the credit cycle. Hedge funds, money market funds, and investors were exposed to investments that had no willing buyers and hence no market value. Demand for safety reached amazing levels sending short term Treasury Bills to dramatically high prices (low yields). Yields on longer term Treasury Bonds followed suit anticipating a Federal Reserve that would respond to the credit crunch. 10-year Treasury bonds rallied to 4.33% before ending the quarter at roughly 4.60% on renewed concerns about inflation due to a weak US dollar and higher commodity prices.

Our bias to quality was beneficial as spreads on corporate bonds widened from multi-year lows. We will seek to take advantage of any quality names that experienced weakness due to market conditions, but had little or no disruption in fundamentals. September and October are historically not great months for fixed income performance, but the uncertainty of economic growth should provide support for bond prices through the end of the year.

Economic Outlook

The third quarter of 2007 may go down as one of the most volatile in recent years. Not only did financial assets experience wide swings in price, but the expectations with respect to future economic growth were equally as volatile.

Early in the quarter most expected the economic expansion to continue in spite of the trouble in housing. It was even anticipated that the Federal Reserve (Fed) might have to raise interest rates due to oil induced inflation. By the middle of September, however, it became clear that the melt down in housing, especially the sub-prime market, could throw the economy into a recession and quick action by the Fed was needed.

The extent of the weakness in housing became clear in August. Lenders such as Countrywide found themselves facing defaults and the lack of funds to support housing. Holders of sub-prime loans suffered the most as foreclosures and defaults grew. Also, asset prices fell and real estate investment funds were faced with large withdrawals and were, in many cases, unable to meet investor demand resulting in a credit crunch. Tighter credit conditions were beginning to affect business and consumer spending, the backbones of our economy. To provide some relief the Fed took an unusual step on August 17th by lowering only the Discount Rate, the interest rate at which banks borrow from the Fed, by 0.5% to 5.75%. A change in this rate is normally associated with a change in other rates and is usually symbolic in nature as banks do not like to borrow from the Fed. With this change, the Fed was letting it be known that credit was available, if needed.

The Fed had obviously underestimated the economic consequences of the deterioration in the housing market. However, reality set in with the employment report of September 7th. Payroll employment in August fell by 4,000, much weaker than the 100,000 gain expected. The revisions to the reports for June and July also revealed a net loss of 81,000 payroll jobs. Construction employment declined by 22,000 and manufacturing employment plunged by 46,000. Household employment also fell by 316,000.

The threat of a recession became real with the August employment report, and on September 18th the Fed lowered interest rates for the first time in four years. The Federal Funds rate was reduced to 4.75%, a 0.50% reduction. Banks immediately lowered the Prime interest rate to 7.75% from 8.25%. This change should help ease the credit conditions in the housing market as many adjustable rate mortgages due to reset are tied to the Prime rate. In addition, lower rates will free up credit in the banking system that can be used to support housing and other types of borrowing. The Fed also lowered the Discount rate to 5.25%, the second decline in less than two months.

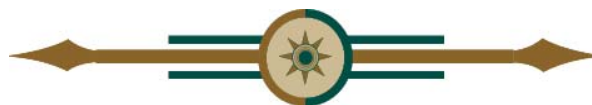
Looking forward, the Fed will be vigilant and continue to lower rates, if needed, in order to avoid a recession. We still have some risk of inflation as oil prices are at record highs, but without a tight labor market it is small, leaving the Fed with room to reduce rates further. Lower rates with a moderately growing economy and only minor inflation should be positives for the markets into 2008.

Market Indicators

(Total Return Through 9/30/07)

	52-Week Change	Changes Since 12/31/06
S&P 500	16.44%	9.13%
DJIA	21.68%	13.31%
NASDAQ	20.52%	12.48%
RUSSELL 1000	16.95%	9.32%
RUSSELL 1000 Growth	19.36%	12.67%

Source: Bloomberg



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