

GREENWOOD

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Insights



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The Stock Market

To quote T.S. Eliot from *The Hollow Men*: “This is the way the world ends, not with a bang but a whimper.” In this case it was not the world that ended with a whimper, but the stock market in 2007. Despite a valiant effort at a rally in early December, the equity market ended on a sour note, with the first negative fourth quarter performance since 2000. Not even Santa Clause (or Fed chairman Ben Bernanke) could help stocks overcome the negative drum beat of housing and credit market turmoil. Throw in \$95+ oil and some negative geopolitical news and one could well understand why stocks had a tough November and December. For the fourth quarter ended December 31, 2007, The S&P 500 ended down -3.8% (-3.3% including dividends). The market still managed a gain for the year, ending up 3.5% (5.5% including dividends) for 2007. For comparative purposes, the Russell 1000 Growth was up 10.5% for the year while the Russell 1000 Value Index ended down -2.7%. These indices both represent large-capitalization companies but with different concentrations in various sectors (Growth having more Technology, Value having more Financials as an example). The Russell 2000 Index, representative of small-cap companies, ended the year down -2.7%.

Sector returns during the quarter largely reflected the themes that played out during the year as a whole. That is, internationally focused sectors such as Energy and Materials and Technology topped the performance list for the quarter. By contrast, U.S. centric sectors like Financials and Consumer Discretionary were the worst performing sectors for the quarter and the year. Energy and Materials stocks were driven by record oil and commodity prices as strong global demand outweighed slower growth in the U.S. Industrials and Consumer Staples, also beneficiaries of foreign exposure and a weakening dollar, outperformed the broader market as well. The troubles in Financials and Consumer Discretionary stocks were linked to a weakening housing market and its impact on spending as well as financial instruments linked to mortgages. As we have alluded to in past writings, the bottom in housing could be

months away, but certainly the stocks in these two sectors have started to price in the reality of the situation. Despite stronger than expected GDP in the middle part of this year, it appears that growth is slowing in U.S. and other developed countries around the world. How the Federal Reserve handles this slowdown in the face of a temporary rise in inflation will determine how the equity market responds as GDP likely slips to around 1% in the first quarter of 2008. While earnings growth is also moderating (or falling in the case of certain sectors), valuations remain reasonable for stocks. In addition, whereas we had private equity funds looking for values in the first half of 2007, today Sovereign Wealth Funds, created by many oil rich countries as well as China, are circling the U.S. stock market in search of investment opportunities. Bottom line, the equity markets are likely to remain volatile over the coming months as investors adjust to slowing economic and earnings growth.

The Bond Market

The deterioration of the US economy, as discussed further in the Economic Review section below, and the continued disruption of the credit mechanism propelled US Treasuries for the quarter. The seasonal weakness in bonds historically seen in September and October did not materialize this year. Prices on Treasuries hit the highs of the year in late November in anticipation of further rate cuts by the Federal Reserve's Open Market Committee. The 5-Year Treasury was the best performer on the yield curve for 2007 with a total return of over 10%.

Corporate bonds, especially those of financial companies, continued to struggle as investors sought the quality of Treasuries. For the year, an index of 5-10 Year Corporate Bonds underperformed its comparable index of 5-10 Year Treasury Bonds by nearly six percentage points (600 basis points). The subprime problems and its spillover into securitized debt markets remain in a longer and deeper cycle than most thought. One victim was the State of Florida Local Investment Pool. When its \$1.5 billion of

subprime-related investments were disclosed, some of its 1,000 investors (towns and school districts) took out \$12 billion of deposits in the \$26 billion Pool. To stem a further “run”, the assets were frozen while a plan could be devised to remedy the situation.

We continue to favor higher quality bonds. The avoidance of riskier bonds in search of higher yield has benefited us. We had a bias to US Treasuries and Federal Agencies in 2007, but the recent increase in Corporate Bonds spreads (the amount over Treasuries that corporate issuers must pay investors) is substantial. We will look for opportunities to increase our exposure to high quality Corporate Bonds. If the Federal Reserve focuses on sustaining economic growth and financial companies honestly value their holdings, we should see a decrease in corporate spreads to Treasuries in 2008.

Economic Outlook

The economy ended 2007 in a very weak condition. The eruption of the financial volcano that began in the third quarter continued to flow red ink during the final quarter of the year. Homeowners faced with falling home prices and resetting interest rates at higher levels on subprime loans made during the easy credit years found themselves unable to make mortgage payments or secure refinancing. Higher energy prices also added to their problems as more funds were needed to pay energy bills. As a consequence, defaults and foreclosures ballooned. One financial institution after another began recognizing losses on their holdings of assets containing subprime loans.

By the end of 2007 it became clear that the housing meltdown and higher energy prices were beginning to impact the overall economy and a recession was a possibility. The growth rate of 4.9 percent in Gross Domestic Product (GDP) that was recorded during the third quarter was not sustainable and growth in the final quarter would probably be closer to a 1.0 percent rate. Housing accounts for a large portion of the wealth of the consumer and as this market deteriorates so does consumer confidence and spending, the main driver of our economy. Consumer confidence as measured by both the Michigan Index of Consumer Sentiment and the Conference Board’s Index of Consumer Confidence did manage to increase slightly over the holiday period but the decline was dramatic for the year. The Michigan Index and the Conference Board Index fell by 17.4 and 18.7 percent, respectively during 2007.

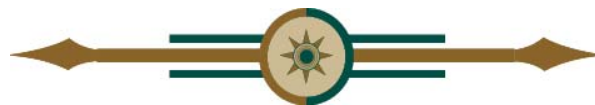
The fall in consumer confidence along with the effect of the subprime market collapse on financial institutions forced the Federal Reserve (Fed) to lower interest rates for the third time this year in December. The Fed lowered the federal funds rate by 0.25 percent to 4.25 percent, a decrease of 1.0 percent over what it was in August. In addition, the Fed has been forced to take some unique steps to provide liquidity to the financial system. With the reluctance of banks to borrow from the Fed and the lack of funds available from other banks that refuse to lend to troubled institutions, the Fed instituted an auction system for funds and relaxed the collateral requirements for banks that borrow from the Fed. In spite of energy induced inflation, the Fed is obviously concerned that a breakdown in the financial markets could lead to a recession.

Looking forward, most analysts, including Greenwood Capital, do not expect a recession. The growth will slow from the rapid pace of the third quarter but the economy should avoid a recession. As 2008 unfolds the Fed will remain vigilant and will probably continue to lower interest rates unless we get a real spike in inflation. Lower rates and easier financial conditions should begin to alleviate the stress on the consumer and the business sector caused by the housing breakdown. The labor market is still strong and will continue to support consumer spending. Likewise, the industrial sector should thrive as foreign demand for our goods and services continues to grow due to the weak dollar. As for the financial markets, we expect continued volatility but with the Federal Reserve as our friend the markets should move higher as the year progresses.

Market Indicators

	52-Week Price Change	52 Week Total Return
S&P 500	3.53%	5.49%
DJIA	6.43%	8.88%
NASDAQ	9.81%	10.66%
RUSSELL 1000	3.86%	5.79%
RUSSELL 1000 Growth	10.53%	11.81%
RUSSELL 1000 Value	-2.66%	-0.18%
RUSSELL 2000	-2.75%	-1.56%

Source: Bloomberg



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