

GREENWOOD

CAPITAL

Insights



The Quarterly Publication of Greenwood Capital

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July 2008

The Stock Market

For anyone who has ever been to Disney World and ridden Space Mountain, the fluctuation in the stock market during the second quarter will seem eerily familiar. Some might even get that same queasy feeling as you look at the sharp drop that occurred from mid-May through the end of the quarter in June. Despite all the ups and downs though, we are not far from where we were at the end of March, but for some reason it sure feels worse. Perhaps the \$40 move up in oil prices has something to do with that. Anyone got a Prius they are looking to sell? Sorry to digress – looking at the numbers for the quarter the S&P 500 fell -3.2% (-2.7% including dividends). For comparative purposes, the Russell 1000 Growth was actually up slightly, +1.2% for the same period, while the Russell 1000 Value Index (with a heavy weight in Financials) was down -5.3%. Both of these large-cap indices are down for the year-to-date period, -9.1% and -13.6%, respectively. The Russell 2000 Index, representative of small-cap companies, interestingly was about flat for the quarter +0.6%, but still down over -9% for the year. Similar to last quarter, international stocks followed the broader market down, with the Morgan Stanley EAFE Index, a measure of developed international markets, falling -1.9% for the quarter and -10.5% for the year-to-date. While not a fun ride for most global equity markets, China was particularly hard hit, trading down over -20% for the quarter. Since peaking last October, the Chinese Shanghai index is down over -55%. Now that makes Space Mountain look like a porch swing.

Sector returns were squarely in the negative camp, although five of the 10 economic sectors still outperformed the broader market for the quarter. At the extremes were Energy (up +17%) and Financials (down -18%). Not surprising given the move higher in oil for Energy and the credit problems for Financials. Following Energy, Utilities and Materials also performed well in the quarter, up +8% and +4%, respectively. Technology and Healthcare also bested the overall market for the quarter. The economically sensitive sectors of Consumer Discretionary and Industrials were near the bottom, both down over -7.5%. Surprisingly, the normally defensive area of Consumer Staples, the best performing sector in the first quarter, was down over -5% in the second quarter. For the year-to-date period, the market performance is much narrower, with Energy and Materials the only positive sectors over this period. In addition, six of the 10 economic sectors are down over -12% through June. To sarcastically paraphrase Bill Murray from the movie Caddyshack – “So we got that going for us, which is nice.”

All joking aside, this has been a very difficult market environment. The sell-off from late May through June has created some opportunities in very well run and established companies, and we continue, albeit prudently, to take advantage of those situations. Stock markets around the world will remain volatile over the coming months as there is no shortage of issues to grapple with every day. However, the market will adjust, discount the news and move forward. In the interim, we will endeavor to navigate our clients through this challenging period utilizing our extensive market experience and conservative investment process and philosophy.

The Bond Market

Our last quarterly letter left you with the thought that US Treasury bonds were fully priced and we would look for acceptable swaps into high grade corporate bonds. This proved to be an appropriate strategy as corporate bonds outperformed US Treasuries by roughly 200 basis points for the quarter. Only the shortest Treasuries escaped the quarter with a positive return while the 2-year, 5-year, and 10-year bonds were lower by roughly 1%, 3%, and 3 ½%, respectively. Improving equities early in the quarter, inflation concerns and hawkish rhetoric from Federal Reserve members were the reasons for the decline in Treasury prices (rise in yields).

Also in the last quarterly letter, we spoke about the challenges facing the municipal bond market. Two of the largest insurers of municipal bonds, MBIA and AMBAC, were stripped of their top ratings in June because of subprime-related losses. Many municipal investors purchase bonds based on the overall rating; which, until now, those with insurance were rated triple-A. We remain focused on the underlying issuer and its rating. While we certainly have bonds affected by this downgrade, we are comfortable with the underlying issuers. In fact, we view this as an opportunity to add more municipal bonds at attractive levels.

We expect continued volatility in the fixed income markets in the coming quarter. Being a presidential election year, there is no shortage of promises by either party to win votes, especially with oil prices elevated and consumer confidence at decade

lows. We are certain to see increasing talk of a higher deficit and more inflation rhetoric, which will pressure bond prices. Will foreign investors continue to buy US bonds given the weaker US dollar? If they do, as a “safe haven” from other investments, this will support bond prices. This is an environment where one should be fairly neutral. As stated above, we see value in municipal bonds, but will remain cautious in adding any more corporate bond exposure.

Economic Outlook

Oil has overtaken the housing meltdown as our major economic problem. Oil prices have been high for a while but during the second quarter prices reached a level (above \$140 per barrel) that far exceeds what most people expected. Oil will likely dictate the course of the economy and the markets for the remainder of the year and on into 2009.

Higher energy prices are impacting consumer spending, serving as a tax on the consumer and absorbing funds that could be spent on other goods and services. Even more importantly, higher energy prices may cause a rise in the overall level of inflation. Faced with an acceleration of inflation, the Federal Reserve (Fed), as well as other central banks around the world, will focus on the prospects of having to raise interest rates rather than lowering them. Higher interest rates will, in turn, increase costs to both businesses and consumers and may adversely affect future economic growth.

Inflation is currently not a major problem, but the Fed would rather raise rates and err on the side of slowing the economy rather than risk an acceleration of inflation. At their last meeting in June the Fed elected to hold interest rates steady (federal funds at 2%), ending the aggressive easing policy that began last August. Whether the Fed votes to increase rates later this year will depend upon whether the rate of core inflation (inflation less food and energy price changes) rises. As measured by the Consumer Price Index (CPI) core inflation over the past 12 months increased by 2.3%. Generally the Fed would like to see core inflation at less than 2%. Up until now the rapid rise in energy and food prices has had a limited effect on the prices of other products as the weakness in the economy has prohibited businesses from being able to pass

along these higher costs to the consumer. This has helped to keep inflation in check.

In spite of all the headwinds – mainly oil and housing – the economy expanded at a 1% rate during the first quarter and, thanks to government rebates, we probably grew at a similar pace or better during the second. Of course, the boost from the rebates will fade as the year proceeds and with consumer confidence at the lowest level it has seen since 1974, the year of the Arab oil embargo, the prospects for continuing economic growth is at risk.

At what level will oil prices peak is anybody’s guess. Prices are impacting to a greater and greater degree spending decisions by both the consumer and the businessperson. If this trend continues, i.e. less demand for gasoline due to less driving, we could get some relief from the relentless rise in energy prices. Any relief would be welcome and could serve as a catalyst for future growth. Attaining a peak in the price of oil would also reduce inflation expectations which would be positive for the financial markets.

Even though the pain of higher energy prices is substantial, over the long run these higher prices will encourage us to develop alternatives and promote conservation, both of which will benefit us as we reduce our dependence on foreigners for the energy to drive our economy. Rest assured OPEC does not want this to happen. The immediate future may look uncertain, but we will make the adjustments necessary to return to better times. Such is the nature of capitalism.

Market Indicators		
	YTD 2008 Total Return	52 Week Total Return
S&P 500	-11.91%	-13.12%
DJIA	-13.38%	-13.28%
NASDAQ	-13.18%	-11.19%
RUSSELL 1000	-11.20%	-12.36%
RUSSELL 1000 Growth	-9.06%	-5.96%
RUSSELL 1000 Value	-13.58%	-18.79%
RUSSELL 2000	-9.37%	-16.19%
MSCI EAFE	-10.50%	-10.05%

Source: Bloomberg



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