The Quarterly Publication of Greenwood Capital
(877) 369-5390 (toll free) www.greenwoodcapital.com January 2009

The Stock Market

President FDR reportedly once said, "When you get to the end of your rope, tie a knot and hang on." I think investors in 2008 have tied a few knots during the year only to see them come loose. But maybe, just maybe, the last knot, tied by the market in late November, will hold on so we can start to climb back up. After hitting a low on November 20, 2008, the market is up nearly 20%. Little solace I realize for those that are still down significantly for the year, but to quote the late songwriter Johnny Mercer, we've "got to accentuate the positive" and "eliminate the negative." The year 2008 will go down as one of the worst in market history, but it's history and in the books. By the numbers, the quarter was one of the worst, with the S&P 500 and Russell 1000 Growth Index both falling over -20%. Specifically, the S&P 500 was down -23.0% (-22.4% including dividends) and the Russell 1000 Growth was down -23.4% (-23.0% including dividends). For the year, both indexes are down over -35%. International stocks faired better in the quarter, with the widely followed international EAFE index down "just" -19% but for the year still ended down over -40%.

The market reaction to the global slowdown / recession that started late in the third quarter, accelerated in October and November, as economies around the world seemed to virtually grind to a halt. The damage to the market on a sector basis was widespread and similar to the third quarter. Energy and Materials were again two of the worst performing sectors, along with Financials, all down in excess of -25%. While no sector survived the carnage unscathed, Healthcare and Consumer Staples again faired the best (relatively speaking) with each down "only" -14% to -15% for the three months ended December 31, 2008. After faltering in the third quarter, Utilities also held up as investors looked for higher yields. Sector performance for the year was much the same, with Energy, Financials and Materials bringing up the rear, down -45% to -55%, and Consumer Staples and Healthcare in the lead, down -15% to -25%.

It is difficult to put into words what occurred in the stock market during 2008. What were once considered "blue-chip" companies disappeared seemingly overnight as one unbelievable market event after the other seemed to happen with regularity. Yet here we are, bruised and battered, but still kicking. Winston Churchill once said, "For myself I am an optimist – it does not seem to be much use being anything else." I tend to agree with that sentiment, but recognize we must also be realists as well. I feel extremely confident in saying that the market in 2009 will be better than 2008. So that's a range of -35% and higher. Not really sticking my neck out in saying that I guess, but in all seriousness, I think we will end up for the year, perhaps 10-15% higher. That's the optimist. However, the journey between December 31, 2008 and December 31, 2009 will be a bumpy one, filled with peaks and valleys, so hang on to that knot tightly – that's the realist.

The Bond Market

Not to be outdone by the equity markets, the fixed income world experienced historical moves during the quarter. The Federal Reserve officially took the federal funds rate down to a range of 0% to 0.25%. Rates on Treasury bonds followed the funds rate lower with the 10-Year Treasury bond yielding a lowly 2.06% at the end of December 2008 and the rate on 3-Month Treasury bills briefly crossing into negative territory. Certainly, there was no shortage of events to scare investors into the safety of the US Treasury. To us, this seems a bit overdone.

Credit selection proved to be extremely important in 2008 as we saw several financial names disappear and others experience much lower prices. The interest rate spread on intermediate investment-grade bonds reached a peak of 237 basis points over treasuries in November before ending the year at 202 basis points. For reference, the highest it reached prior to 2007 was 105 basis points over Treasuries in 2002. We see value in corporate bonds, but credit selection will continue to be a theme for 2009.

Municipal bonds continue to trade "cheap" relative to Treasuries. As we have outlined in every newsletter this year, challenges remain for municipalities from the prospect of declining tax revenues, but we see value in general obligation and essential service revenue bonds issued by municipalities. It will be interesting to see the effects in the municipal bond sector under the new Administration, particularly whether aid is given to municipalities and whether there are changes in the tax treatment of these bonds.

Economic Outlook

What a mess! Nobody could have predicted that the collapse in the real estate market and the financial structure supporting it would have resulted in a major worldwide recession. What seemed to be a problem for only a few firms that had been overly aggressive in issuing and holding problem assets has morphed into a major economic calamity with unemployment rising and businesses closing throughout the world. The year 2009 is beginning with a lot more people out of work and fewer firms around, including household names such as Merrill Lynch and Wachovia. The economy also lost over 2 million jobs and the unemployment rate rose from 5.0% in December of 2007 to 6.7% in November of 2008 (December rate reported on January 9th) the highest since October 1993 and probably going higher.

A retrenchment in consumer spending has been the main culprit. Even with energy prices falling, consumer spending has virtually shut down. Faced with prospects of job losses and home foreclosures consumers have lost confidence in their future well being. Consumer spending fell by 3.8% during the third quarter and continued to decline throughout the holiday season. Only spending by the federal government is making a positive contribution to our economy. The government has opened up the check book, writing checks under TARP (Troubled Asset Relief Program) and other programs to troubled firms. Spending on durable goods such as household furnishings and automobiles – sales fell -32% in December – has been especially hard hit. Without government help both GM and Chrysler were on the verge of bankruptcy at year end – we might see a repeat of this again in March.

The National Bureau of Economic Research has officially declared that the US entered a recession in the fourth quarter of 2007, over a year ago. As measured by GDP (Gross Domestic Product), the economy declined at an annual rate of -0.5% in the third quarter of 2008 and will be weaker during the fourth quarter (reported the end of January), maybe falling by over -5.0%, a major slowdown. Internationally, economies are in as bad if not worse shape. GDP in the European community – Eurozone – and Japan is expected to decline by -5.0% and -7.5%, respectively. Even China will probably record negative growth of around -1.8%.

On the bright side, the weakness in the economy along with the fall in interest rates and energy prices has calmed any fears of inflation for the foreseeable future. As measured by the CPI (Consumer Price Index), prices fell by -1.7% in November and over the past 12 months prices rose by only 2.0%. Excluding the volatile food and energy components – core CPI – prices have risen by a nominal 1.1%, no cause for alarm. In fact, the prospect of deflation, not inflation, is becoming more of concern for the future.

How long will the current recession last? Nobody knows, but historically, when things look the worst, it is a good sign that we are near the bottom. Clearly, weakness in housing and automobile sales will continue to be a drag on the economy during the first half of 2009. Hopefully, the financial stimulus being supplied by the government and the Federal Reserve (Fed) will gain traction as the year progresses. The Fed has lowered interest rates close to zero and instituted a massive policy of "quantitative easing" – buying financial assets in the marketplace to provide liquidity. The Fed is committed to providing whatever capital is needed by the markets, and they have an almost unlimited ability to do so.

Our new Administration is also firmly committed to another economic stimulus package. The package could reach $800 billion. By allocating much of the stimulus to infrastructure improvements (roads, schools, housing, etc.) the Obama Administration hopes to create some 3 million jobs over the next couple years.

As 2009 unfolds we expect both the economy and the markets to recover. Both will be volatile but we should see positive improvements as the year progresses. Low interest rates will support housing, and as the housing market stabilizes – in both sales and prices – we should see an improvement in consumer confidence, a necessary condition for a sustained recovery. Lower energy prices will also serve as a catalyst for future growth. The economy of the future, however, will be different. The government will have a much greater role as both a regulator and owner of businesses. Our hope is that as we recover from the current turmoil that we will return to our capitalist roots which have served our economy and the markets so well.

Market Indicators

	YTD 2008 Total Return[1]	52 Week Total Return[2]
S&P 500	-37.00%	-37.00%
DJIA	-31.93%	-31.93%
NASDAQ	-39.98%	-39.98%
RUSSELL 1000	-37.60%	-37.60%
RUSSELL 1000 Growth	-38.43%	-38.43%
RUSSELL 1000 Value	-36.85%	-36.85%
RUSSELL 2000	-33.79%	-33.79%
MSCI EAFE	-43.09%	-43.09%

1) Through 12/31/08
2) Through 12/31/08
Source: Bloomberg

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