

GREENWOOD

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Insights



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(877) 369-5390 (toll free)

www.greenwoodcapital.com

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The Stock Market

Author Henry David Thoreau once said that “All misfortune is but a stepping stone to fortune.” Translated into the context of the stock market, we should all be rich in the future because we have seen enough misfortune over the past 18 months to last a lifetime! The first quarter of 2009 looked eerily similar to the fourth quarter of 2008, with a brutal down turn into a panic low and then a 20%+ rally off of the bottom. Unfortunately, the low established in March at 667 on the S&P 500 was a bit lower than that of November at 741. Thinking back to our commentary last quarter, the knot we tied at the end of our rope slipped a bit (but it didn’t completely unwind). When the first quarter finally ended, we logged the sixth straight quarterly decline for the market. The S&P 500 and Russell 1000 Growth Indices ended down -11.0% and -4.1%, respectively, including dividends. Other areas of the market were mixed. Small-cap stocks, as measured by the Russell 2000 index, fell -15.0% and developed international markets were down -14.0% (using the EAFE index). However, emerging markets, measured using the MSCI Emerging Market Index, posted relatively better returns, ending up approximately +1.0% for the quarter. This performance was led most notably by the move higher in China.

Sector performance for the quarter was more differentiated, with five sectors outperforming the Russell 1000 Growth index and three sectors actually posting positive returns in the quarter. Materials, Telecom Service and Technology were all up for the quarter, between 4% and 7%. The leadership of Materials, up around 6%, may have been tied to the jump in China we referenced above. Consumer Discretionary (surprisingly) and Healthcare also beat the index, but were down between -2% to -4%. Not surprisingly, Financials was the worst performing sector, down nearly -18%, followed not too distantly by Industrials and Utilities, both down near -15% over the same time period. Perhaps the most unexpected return for the quarter was in Consumer Staples, ending down over -8%. After performing admirably in 2008, this traditionally defensive sector of the market gave back

some in the first quarter of 2009. It should be noted that during the rally of the past three weeks, you definitely started to see some sector rotation into more cyclically sensitive areas of the market, including Financials.

We ended our commentary last quarter noting “that the journey between December 31, 2008 and December 31, 2009 will be a bumpy one, filled with peaks and valleys....” We think going from a high of 935 on January 6 to an intraday low of 667 on March 6 and closing the quarter at 798 on March 31 fits that description. I would expect more volatility ahead as the market tries to feel out when the economy will bottom. This process is made more difficult given the interventions and constant tinkering coming out of Washington, DC; but that’s a whole other commentary.

The Bond Market

After the strong finish to 2008, longer-dated Treasury bonds began 2009 with one of its worst January performances on record as investors took profits. We discussed in our last newsletter that we thought US Treasury bond strength “seems a bit overdone” and we were increasing our allocation of high quality corporate bonds. We continue to feel this way. Despite the Federal Reserve’s best efforts to lower market rates through purchasing Treasury bonds (on top of lowering the Federal Funds Rate to 0% last December), rates should rise due to the amount of issuance we will see from the Treasury Department – tripling sales to a record \$2.5 trillion – to fund the many government programs announced recently.

Investment-grade corporate bond spreads – the amount of interest over Treasury bonds required for corporate credit risk – narrowed to 186 basis points from 202 basis points at the beginning of the year. The 3-month TED spread (the gap between what banks and the Treasury pay to borrow money for 3 months) narrowed to 99 basis points from 135 basis points on December 31st and a high of 464 basis points in October. These are signs that the credit freeze is thawing.

We also continue to favor high quality tax-exempt municipal bonds. Tax rates are certain to increase and municipalities have limited capacity to issue new debt making these a desirable investment.

Economic Outlook

Over the past two quarters the US Government and the Federal Reserve have assumed a much greater role in controlling the economy. The government now owns and has the potential to eventually own and/or regulate a larger share of American business, and as we tackle healthcare reform, this role will expand. We admit that the financial system was in a mess and needed some help, but we fear we may be overreacting. History may remember 2009 as the year that the capitalistic ideals that made our country great died. Free enterprise and the profit motive will play a smaller role in the future. Furthermore, the people will rely more and more on the government to provide for their needs – healthcare, education and an acceptable standard of living. I hope the Scottish historian, Alexander Taylor, writing in 1787 was not correct when he stated: “A democracy will continue to exist up until the time that voters discover that they can vote themselves generous gifts from the public treasury”.

With government budgets in the trillions - \$3.5 trillion proposed for 2010 – and the deficit growing almost exponentially - \$1.75 trillion for 2009 – one cannot argue that government is assuming a greater role. Government deficits for the years 2010 through 2019 are projected to equal 5.3% of our Gross Domestic Product (GDP), the worse peace time deficits ever recorded. Whether economic growth will allow the government to meet future obligations having to finance an \$11.5 trillion debt (some projections are higher) remains to be seen. We hope that inflation and interest rates remain under control and foreign holders of our securities do not decide to liquidate them all at once.

Times are interesting and challenging, but things always look the worse when we are near the bottom. The massive spending by the government and the “quantitative easing” by the Federal Reserve appear to be gaining traction and things are looking a little brighter. Also, time is on our side as recessions do not normally last this long – began October 2007. The recent improvement in the stock market may also be a sign that investors are looking to better times in the future.

Recent statistics on housing are improving and a bottoming in the real estate market would do wonders

for consumer confidence and encourage consumers to spend. Housing starts, new home sales, and existing home sales increased by 22%, 5.1% and 4.7%, respectively in February. Mortgage rates are historic lows – under 5% and mortgage applications are substantially higher. Even though refinancing has been a large part of mortgage loan activity, it does free up discretionary income for the consumer. Without consumer spending – historically 70% of GDP- we cannot have a sustained economic recovery. It has improved and is on tract to grow by 1.1% in the first quarter. However, employment statistics are very weak which does not bode well for a rapid rebound. Our economy lost over 1.8 million jobs in the first quarter and over 5 million since the recession began. The unemployment rate is 8.5%.

Looking forward, we do expect the economy to improve during 2009 with better growth in 2010. GDP fell by 6.3% in the fourth quarter and for the entire year 2008 it grew by only 1.1%. The massive spending by the government along with historically low interest rates will pull us out of this recession. The ride may be volatile but some of the prosperity of the past should return. A major concern that we must address in the future is how to control deficits and the federal debt. They have to be addressed but can only be done by decreasing government spending and/or increasing revenue. It will be tough to decrease spending given the greater role that the government will have. So, how does the government increase revenue? Growth will help, but I expect you know the real answer.

Market Indicators		
	YTD 2009	
	Total Return¹	52 Week Total Return²
S&P 500	-11.01%	-38.09%
DJIA	-12.48%	-35.93%
NASDAQ	-2.79%	-32.25%
RUSSELL 1000	-10.44%	-38.25%
RUSSELL 1000 Growth	-4.09%	-34.27%
RUSSELL 1000 Value	-16.76%	-42.42%
RUSSELL 2000	-14.95%	-37.50%
MSCI EAFE	-13.96%	-46.34%

1) Through 3/31/09
 2) 12 Months Ended 3/31/09
 Source: Bloomberg



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