

# GREENWOOD

## CAPITAL

### *Insights*



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### **The Stock Market**

Oh what a difference a quarter makes! The rally that started in early March continued through the second quarter of 2009, albeit with a brief break in the last few weeks. But hey, with the last positive quarter way back in 2007, we'll take it. Breaking it down month by month, April saw a powerful move higher, up over 9%, followed by another 5% in May. June started strong through the middle of the month, but ended with a thud over the last two weeks. The good news is that volumes seemed to dry up as well indicating perhaps investors were simply moving to the sidelines rather than aggressively selling stocks. From a technical perspective, we achieved an important milestone with the 50-day moving average crossing above the 200-day moving average (sometimes referred to as the "golden cross" among market technicians). This usually indicates a change in trend in the market. In fact, since 1929 there have been 14 instances where a rising 50-day has broken up through a declining 200-day and on average the market has been up over 18% twelve months later. However, much of this increase tends to occur in the outer months. We'll see if this repeats for our current situation.

For the quarter, the S&P 500 and Russell 1000 Growth Indices ended up +15.93% and +16.32%, respectively, including dividends. Other areas of the market were strong as well with Small-cap stocks, as measured by the Russell 2000 Index, up +20.69% and developed international markets +25.64% (using the EAFE Index). Emerging markets, measured using the MSCI Emerging Market Index, continued their move higher, ending up +34.73% for the period ending June 30, 2009.

Sector performance for the quarter shifted to more cyclical areas of the market and witnessed a dramatic change at the top. Five sectors outperformed the Russell 1000 Growth Index with all ten sectors posting positive returns in the quarter. Financials went from worst to first, rising over 35% in the quarter. Industrials, Energy, Utilities and Technology rounded out the top 5, all up in excess of

20%. Consumer Discretionary continued its solid performance from the first quarter, and traded higher by 15%. Consumer Staples, Materials, Telecom and Healthcare brought up the rear, but still increased between 8-9% each. Besides being a defensive sector in a cyclical market, Healthcare may have also been weighed down by the continuing debate in Washington regarding healthcare reform.

I think it's safe to say that the easy money has been made in the move off the bottom of early March. From current levels, it will be a harder climb as we head into the second half of the year. The "green shoots" of economic recovery will have to start growing in order for the market to move sustainably higher. We believe that can happen, but investors need to be mindful that it will likely not be in a straight line.

### **The Bond Market**

The treasury market recorded the largest back-to-back quarterly losses, as measured by the Merrill Lynch US Treasury Master Index, since this index began in 1978. In fact, it took a last minute rally in treasuries to keep this quarter from being the worst since 1980. The factors contributing to this include "less bad" economic data, improving equity markets, the continued issuance of treasuries (government borrowing to fund the many stimulus programs), concern over future inflation, and talk from other countries of diversifying away from dollar-based assets. We transitioned our fixed income portfolios to an underweighting of treasuries over the past year and continue to believe high quality corporate bonds offer the best return potential.

Investment-grade corporate bond spreads – the amount of interest over Treasury bonds required for corporate credit risk – continued their narrowing on the year to 110 basis points (100 basis points = 1%) from 186 basis points at the beginning of the quarter and 202 basis points at the start of 2009. Intermediate corporate bond indices have

outperformed similar government bond indices by roughly 1,000 basis points for the year as the crisis of confidence thaws. Credit selection remains the dominant factor in our four factor process. Debt-heavy companies should be avoided as they will continue to find financing difficult and expensive.

The yield curve steepened substantially over the quarter – that is, yields on longer-dated maturities rose higher than shorter-dated maturities. The difference between the 2-year treasury yield and the 10-year treasury yield rose above 250 basis points, matching the widest margins of 2003 and 1992. Our bias is for higher rates over the next year, but not to the degree that prevents us from extending our maturities to take advantage of the higher yields.

### **Economic Outlook**

Recent news headlines are beginning to focus more and more on inflation and the effects of the enormous federal debt on future generations. While these issues are troubling, this change in focus may not be all bad as it could be signaling the end of the recession. So far we have been able to put some major headaches behind us, i.e. the bankruptcy of GM and Chrysler, and the economy does appear to be healing.

What type of economic recovery we have – rapid or slow – is up for debate. Regardless, the key to a sustained recovery will depend to a large extent upon the rebound in employment and to what extent future inflation is affected by the massive amount of stimulus spending that has been thrust into the economy.

Currently we still have a deteriorating job market but the rate of decline is moderating. The unemployment rate was 9.4% in May with a reduction of 345,000 payroll jobs, less than expected. These statistics are terrible, but the lost jobs represent a vast improvement from earlier this year when job losses were around 700,000 per month. If the trend in payroll employment continues to improve, we could see positive job growth before the end of the year. The unemployment rate, on the other hand, will likely continue to rise as new and displaced workers return to the labor force.

As for inflation, it is currently non-existent. Since May of last year the Consumer Price Index actually declined by 1.3%, thanks to weak demand and falling home and

energy prices. The concern we have for the future is that the stimulus dollars being pumped into the system could drive prices higher. Inflation can be simply defined as “too many dollars chasing too few goods”. Without an increase in output or a move by the Federal Reserve to absorb some of the excess liquidity in the system, we can expect inflation to accelerate forcing the Federal Reserve to raise interest rates, not what we need right now.

Our enormous federal debt could be a major future problem. In the current fiscal year alone the government will add around \$1.8 trillion to the debt. With the Treasury having to finance future deficits as well as refinance existing debt, interest rates will need to rise, making it more expensive for consumers and businesses to borrow funds. At some point this debt must be addressed and raising taxes may not be the best solution. Higher taxes will absorb funds needed by the private sector and can destroy the economic incentive to succeed – the foundation of capitalism.

Looking forward, our hope is that we achieve a level of economic growth that is capable of keeping inflation in check, supporting increased employment and allowing for an orderly decline in the federal debt. Such an outcome is possible if we allow our businesses and industries, strengthened by the infusion of stimulus funds, to return to their free enterprise roots and capitalist ideals. If this happens we could be facing the best of times. Without this, it may be the worse of times. Only time will tell.

<b>Market Indicators</b>		
	<b>YTD 2009 Total Return<sup>1</sup></b>	<b>52 Week Total Return<sup>2</sup></b>
<b>S&amp;P 500</b>	+3.16%	-26.21%
<b>DJIA</b>	-2.01%	-22.99%
<b>NASDAQ</b>	+16.98%	-19.13%
<b>RUSSELL 1000</b>	+4.34%	-26.68%
<b>RUSSELL 1000 Growth</b>	+11.53%	-24.50%
<b>RUSSELL 1000 Value</b>	-2.87%	-29.03%
<b>RUSSELL 2000</b>	+2.64%	-25.01%
<b>MSCI EAFE</b>	+8.09%	-31.26
<b>MSCI Emerging Markets</b>	+36.01%	-28.07%

1) Through 6/30/09  
2) 12 Months Ended 6/30/09  
Source: Bloomberg



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