

GREENWOOD

CAPITAL

Insights



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The Stock Market

There is an old saying on Wall Street that “the trend is your friend.” That has certainly been the case since the market bottomed on March 9, 2009. With only a few hiccups along the way, the market trend has been up, up and away. After trading in a tight range for much of November and December, the Santa Claus rally came just in time to push the market toward new highs for the year. While returns for the fourth quarter were more muted than those of the second and third quarters, they were positive none the less. For the three month period ended December 31, 2009, the S&P 500 and Russell 1000 Growth Indices ended up +6.0% and +7.9%, respectively, including dividends. Other areas of the market were strong as well with Small-cap stocks, as measured by the Russell 2000 index, up +3.9% and developed international markets were +2.2% (using the EAFE index). Emerging markets, measured using the MSCI Emerging Market Index, continued their move higher, ending up +8.5% for the quarter. For 2009, the S&P 500 and Russell 1000 Growth Indices ended up +26.5% and +37.2%, respectively, including dividends. What a difference a year makes!

At the sector level, Technology continued to lead the market for the quarter and the year, posting a +12% and +62%, respectively, during these periods. Consumer Discretionary also continued to be strong as holiday spending came in better than expected. The sector ended up +8% and +43% for the quarter and year. In a bit of a surprise, the market witnessed some rotation during the fourth quarter as Healthcare (+7%) and Utilities (+3%) picked up, although both sectors still lagged the market for 2009. After being the top performing sector in the second and third quarters, Financials fell to the bottom of the pack, rising slightly for the quarter (+2%). This is a sector we are watching closely as we believe it is a critical piece to the sustainability of a market recovery going forward. Other sectors were mixed during the quarter, with only three outperforming the Russell 1000 Growth Index. For the year-to-date period, Technology, Materials and Consumer Discretionary led the way, with all other sectors posting positive returns, but lagging the index (Russell 1000 Growth).

With the market up nearly 70% from its lows, it is understandable and appropriate to take a more cautious view as we head into a new year. We continue to see the economy recovering, albeit slowly, from the recession in 2008 and early 2009. This should support upward revisions in earnings for companies and provide a fundamental foundation for continued gains in stocks. However, the market will face the headwind of

the Federal Reserve beginning to remove its accommodative monetary policy and the corresponding move higher in interest rates. The uncertainty around the timing and extent of these actions will likely cause some volatility in the market in 2010. We believe the 2004 tightening campaign by the Fed may provide a template for market performance in the months to come. With that in mind, we will continue to watch the labor markets and interest rates closely for signs that we are on track for this scenario. After 30+% returns in 2009, we would gladly take the 8-10% seen in 2004.

The Bond Market

Bond yields stayed relatively stable in the face of higher equity markets for the first two months of the quarter. In December, though, yields made a run at the highs of the year with the 10-year Treasury note finishing at 3.84%. For reference, the low for the year was 2.20%. As we mentioned in the 3rd Quarter Commentary, the Federal Reserve program to support interest rates through purchasing treasury securities ended on October 31, 2009. Longer-dated Treasury bonds followed one of their best yearly performances in 2008 with one of their worst in 2009. The 10-year Treasury lost nearly -10% in 2009. The 2-year Treasury stayed in positive territory in 2009 with a return of just over +1%. Its yield finished the year at 1.14%. The Treasury yield curve widened to historic levels – as measured by the difference between 2-Year and 10-Year treasury yields.

Corporate bonds performed very well in 2009 as investors moved back into riskier fixed income areas. The triple-B rated bonds – the lowest rating in the investment grade universe – returned nearly +28% while the highest quality triple-A rated were up only +3%. We remain overweight the corporate bond sector. We think security selection will become the dominant factor of outperformance for 2010 as the “buy any depressed fixed income security” days of 2009 are over.

Municipal bonds had another strong year – up nearly +7.5% as measured by the Barclays 5-Year Municipal Index. Similar to the corporate bond sector, security selection will play a major factor in 2010 for municipal bonds as states and counties struggle to balance budgets. To the extent that much of the municipal revenues are derived from real estate transactions and sales taxes, there will be challenges to replace the shortfalls in their projections. Nevertheless, with the prospects for higher taxes, municipal bonds are still an attractive option for investors in the upper tax brackets.

Economic Outlook

We're worried! Why should we be worried? The economy is on the mend, inflation is not an issue, the housing market has stabilized and employment statistics are improving. It is true the recession has ended. Economic growth, as measured by Gross Domestic Product (GDP), turned positive in the third quarter of 2009 after four negative quarters. GDP expanded by 2.2% during the third quarter and will probably exceed 3% during the fourth. Inflation is also under control and the recent talk of deflation has subsided. The Consumer Price Index (CPI) increased by only 1.8% over the past year, no cause for alarm. Even the most recent employment statistics are improving. The decrease in non-farm employment in November was only a negative 11,000, the smallest decline in two years, and we should record employment gains, for the first time since December 2007, early in 2010 if not during December – statistics reported on January 8th.

So, why are we worried? We have major concerns regarding the level of debt being piled on the US by government overspending. The government's *modus operandi* seems to be to throw more dollars at any problem rather than to search for more cost effective solutions. The National Debt has increased at an alarming rate. Currently the total debt owed by the federal government exceeds \$12 trillion (12,000,000,000,000). This includes debt held by the public – 44% of total; by foreigners – 25% of total; and by other government agencies such as Social Security and Medicare. Deficit projections for the current fiscal year are also in the \$1.8 trillion range, highest ever.

Our main concern is the ability of the government to finance and refinance future debt without driving interest rates to levels that result in inflation and another recession. US marketable securities issued by the Treasury to finance or refinance current debt increased to a record \$7.2 trillion by November of 2009 from \$5.8 trillion at the end of 2008, a 24% increase. The big concern is finding non government buyers for our debt. China and Japan own almost 50% of the debt held by foreigners, and earlier in December central banker Zhu Min of China implied that the US cannot expect other nations to continue to buy their securities. Fortunately,

the US is still the safest place to invest, but this could change as we pile more and more debt on the world. Interest rates will have to increase if we are going to find buyers for an ever increasing supply of securities. Even with an accommodative Federal Reserve (Fed) – keeping rates low – market forces are looking to the future and driving rates higher. The interest rate on the 10 year Treasury bond has increased from 2.2% at the beginning of the year to 3.8% on December 31 without a policy change by the Fed.

We must address the debt in a meaningful way if we are to avoid what could be major problems in the future. Increasing taxes is not the sole solution. Increased taxes will only add to the negative effects of higher interest rates. We need to support the consumer and the business sector, not punish them with higher taxes and governmental controls. A strong economy, along with curbs on government spending, will help control the growth of the debt and keep interest rates low. We are hopeful that we can make the adjustments necessary to keep our economy strong. Looking forward, we are worried but optimistic.

Market Indicators

| | YTD 2009 Total Return ¹ | 52 Week Total Return ² |
|-----------------------------|--|--------------------------------------|
| S&P 500 | 26.47% | 26.47% |
| DJIA | 22.68% | 22.68% |
| NASDAQ | 45.36% | 45.36% |
| RUSSELL 1000 | 28.45% | 28.45% |
| RUSSELL 1000 Growth | 37.21% | 37.21% |
| RUSSELL 1000 Value | 19.69% | 19.69% |
| RUSSELL 2000 | 27.17% | 27.17% |
| MSCI EAFE | 32.18% | 32.18% |
| MSCI Emerging Market | 78.51% | 78.51% |

1) Through 12/31/09

2) 12 Months Ended 12/31/09

Source: Bloomberg



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