

The Stock Market

Well, if you read our commentary from last quarter, you will appreciate it when we say that Gordon Gekko and all his "*Greed, for lack of a better word...*" got taken to the cleaners in the second quarter of 2010. Watching the market over the past three months, we were often reminded of the first lines of Rudyard Kipling's poem, "If you can keep your head about you when all around you are losing theirs...." The troubles over in Europe, specifically Greece, which seemed to start the market slide in late April quickly gave way to one bad headline after another, including the "Flash Crash" of the Dow on May 6, the ever worsening oil spill in the Gulf and, last but not least, the incredibly succinct and concise, 1,900 page financial reform bill from Congress. Wow, now that we think about it, why wasn't the market down more? All levity aside, we are happy to say good riddance to the second quarter of this newly established decade. Officially, for the three month period ended June 30, 2010, the S&P 500 and Russell 1000 Growth Indices ended down -11.43% and -11.74%, respectively, including dividends. Surprisingly, small-cap stocks held up better than large-caps, falling "only" -9.12%, as measured by the Russell 2000 Index. Developed International markets once again trailed these domestic indices, with developed international falling -13.69% (using the EAFE index). Emerging markets did better, falling -8.37%, using the MSCI Emerging Market Index. This despite a -22.9% drop in China. Year-to-date through June 30, 2010, the S&P 500 and Russell 1000 Growth are down -6.65% and -7.64%, respectively. It feels worse – we know.

The second quarter turned the sector performance on its head. Utilities and Telecom, the two worst performing sectors in the first quarter, were number one and two in the most recent period. Both fell less than -5%. Consumer Staples and Discretionary were the only other sectors that "held up" relatively well, declining less than -10% each. Industrials and Financials, the top of the pack three months ago, dropped toward the bottom, to seventh and ninth place, respectively, falling in excess of -12%. Consistent with the sharp drop in China referenced above, the highly-cyclical Materials sector was the worst performing for the quarter, dropping over -15% for the three month period.

With the market trading the way it did to end the quarter, we can sympathize with Mortimer and Randolph

Duke in the movie *Trading Places* screaming to "turn those machines back on"; however, we are hopeful that cooler heads will prevail in the second half of 2010. In last quarter's commentary we wrote – "while we continue to expect high single-digit to low double-digit returns in the market for the year, we wouldn't be surprised to see more volatility creep into trading as we move through the month and into May and June." In hindsight, perhaps the understatement of the year some would say. We appreciate the challenges out there facing the U.S. and world economy. At the same time, looking at the market trading at 12x a very conservative earnings number of \$80 for 2011 and many major global corporations yielding in excess of ten-year treasury yields, we can't help but think that the markets are pricing in a fairly dire scenario right now.

The Bond Market

Treasury bonds regained a commanding lead in the fixed income market's performance race with a strong rally in the second quarter. Concerns over Europe's debt situation and, more recently, weaker than expected economic data in the US provided the catalyst for the outperformance. Even though the US Treasury continues its massive issuance of debt and the Federal Reserve ended its quantitative easing program, demand for the stability of US bonds from around the world produced the lowest yields (highest prices) in quite some time. In fact, the 2-Year Treasury note currently yields 0.61% - the lowest since its development in 1977. Longer-dated bonds outperformed shorter ones. The performance of the 10 year Treasury was nearly double the performance of the 5 year Treasury bond.

Corporate bonds underperformed Treasury bonds, but still turned in an impressive quarter. Contrary to 2009 and the 1st Quarter of 2010 where lower quality bonds significantly outperformed higher quality bonds, the 2nd Quarter produced very little performance difference in ratings categories – each category was up by roughly 3.00%. We still view Corporate bonds favorably over the valuations of Treasury bonds.

Municipal bonds lagged Treasury bonds to the point where the tax-free municipal yields are nearly the same as the taxable Treasury yields. This is rare, but has happened a few times over the last decade when the absolute levels of interest rates are very low. One reason is the concern over the financial health of

municipalities. It is very important, just as in 2008, to understand the sources of revenue that are used to repay your municipal bonds.

Economic Outlook

The recession which unofficially ended during the third quarter of 2009 has entered a so called "soft patch", i.e. the economy is growing but at a slower pace and not all of the economic news is good. Gross Domestic Product (GDP) expanded by a robust 5.6% in the final quarter of 2009 and a respectable 2.7% in first quarter, but growth may have slowed to less than 2.5% in the quarter that ended on June 30th.

GDP expansion may be less than desired, but it is unlikely that we will double dip into another recession. Businesses are spending even though they are reluctant to add to their payrolls. During the recent recession the US lost over 8.4 million jobs and since the recovery began we have added – through May - less than 800,000 with over half of these government jobs due to the Census. Without a large increase in payroll jobs, the recovery will be lethargic at best. Consumers are also cautious, favoring savings and the reduction of debt to increased consumption. The latest report saw personal income increasing by 0.4% but consumer spending by only 0.2% – enough to keep economic growth positive but not enough to boost it dramatically.

The US has avoided a major economic meltdown but we are not out of the woods yet. We rely on exports to help our economy and with the turmoil in the European community along with the strengthening dollar the demand for our exports is being negatively impacted. Fortunately our two main trading partners, Canada and Mexico, are not in such dire shape. In fact, Canada has weathered the storm better than any other country.

Domestically we are also facing what could be a major economic event. The BP oil spill has the potential to alter the economic landscape for years. Jobs may be created as we fight the spill and BP/Government dollars may provide temporary buying power, but the long run potential destruction of the seafood and tourist industries will be felt for a long time. Many jobs could be lost forever while cleanup jobs will go away. It is far

worse than a hurricane. Homes and businesses can be rebuilt but the marshes and rivers that are vital to the seafood industry may not be able to recover. The spill should also increase energy prices. More controls on production and the imposition of costly requirements on firms seeking resources will drive energy prices higher. Hopefully, the calamity will not be as devastating as many believe.

Depressing news seems to be the norm but there are many positive factors that will help us avoid a double dip recession. As mentioned, business spending and industrial production continue to expand. Industrial production increased by 1.2% in May and at an 8.9% annual rate over the past 11 months. At some point industries will be forced to begin hiring workers. The auto industry is bouncing back. GM recently reported that they will hire thousands of temporary workers – a first step to permanent jobs – to meet growing demand. Housing is still depressed but it is only a matter of time given the low level of interest rates. Inflation is also our friend. Pricing pressures are non-existent allowing the Fed to keep rates low. In closing, we may be in a "soft patch", but the prospects for more robust growth are encouraging.

Market Indicators

	YTD 2010 Total Return ¹	52 Week Total Return ²
S&P 500	-6.65%	+14.43%
DJIA	-5.00%	+18.94%
NASDAQ	-6.62%	+16.04%
RUSSELL 1000	-6.40%	+15.23%
RUSSELL 1000 Growth	-7.64%	+13.62%
RUSSELL 1000 Value	-5.12%	+16.92%
RUSSELL 2000	-1.94%	+21.49%
MSCI EAFE	-12.84%	+6.56%
MSCI Emerging Market	-6.17%	+23.15%

1) Through 6/30/10

2) 12 Months Ended 6/30/10

Source: Bloomberg

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