

# Market Monthly

*An analysis of the economy and the markets*

APRIL 2010

## ■ **The Economy**

The Index of Leading Economic Indicators rose for the 11th-consecutive month, suggesting the economic recovery is well underway. In addition, narrowing credit spreads and improving stock prices also support continued economic gains. The Federal Reserve continued to demonstrate monetary-policy patience, which should keep the federal funds target rate low and help support economic growth. Similarly, on the global front, interest rates seem likely to remain low. The core inflation rate (headline inflation minus volatile food and energy prices) is helping to fuel the Fed's patience. As of the end of March, the annual rate of core inflation was a benign 1.1%. Similarly, the Core Personal Consumption Expenditures Index (PCE) remains within the Fed's "comfort range" of 1% to 2%. Despite the improving economic data, the gains are not yet robust enough to influence the unemployment rate, which remained at 9.7%. The extended period of high unemployment suggests overall economic conditions are not improving much. Government stimulus programs, rather than consumer spending, have accounted for most of the nation's economic growth. On a bright note, consumer spending has been trending upward for the last several months, and March consumer confidence rebounded from February's plunge. But, consumer confidence remains fragile in the face of still-high unemployment and the still-weak U.S. housing market. Mortgage foreclosures have reached record levels, refinancing activity has plunged, and bank lending standards remain tight. In addition, uncertainties surrounding the financial and political implications of the federal government's new health care legislation and other pending regulatory changes may stifle future economic growth. Looking ahead, we expect GDP to remain strong in the near term but eventually slow, as the impact from government stimulus and inventory corrections fades. Overall, even if the economy can overcome its current challenges, the headwinds of higher government regulation, higher taxes and deleveraging, along with the ongoing threat of terrorism, may lead to below-average growth for the next few years.

## ■ **Equity Market**

Stocks posted sharp gains in March, as investors remained optimistic about recent economic advances and improving corporate-sector fundamentals. On the rate front, global interest rates remained low, and the Federal Reserve and many other developed-market central banks maintained their supportive monetary policies. Overall, stock market valuations continued to appear reasonable. Furthermore, with corporate fundamentals improving, mergers-and-acquisitions activity should increase, and large amounts of liquidity still lingering on the sidelines may promote future positive stock market performance. Yet, at the same time, several factors continue to threaten the sustainability of the economic turnaround and stock market performance. Specifically, the massive federal budget deficit and the likelihood of higher taxes are creating headwinds for lasting economic growth. Additionally, cost-cutting efforts, rather than top-line growth, have accounted for much of the improvement in corporate margins. Furthermore, the high unemployment rate, continued consumer deleveraging, and tight bank lending standards are creating additional challenges. Meanwhile, political uncertainty continues to haunt investors. Specifically, several current U.S. government policy initiatives, including the "cap and trade" legislation, tax changes, and financial-sector reforms, likely will result in negative economic consequences. Looking ahead, we believe stock market leadership may shift to select sectors and stocks that lagged during last year's strong rally. The outperformance of lower-quality companies since March 2009 should end, as higher-quality companies are in a relatively better position to access capital markets and benefit from overseas demand. In addition, higher-quality stocks generally have exhibited attractive relative valuations. We continue to believe it's important to emphasize companies exhibiting sound financial strength and valuation. It's also important to note REITs (real estate investment trusts) have raised significant amounts of capital during the past year. Their access to public capital has provided them with a distinct advantage in the current commercial real estate market. We recently initiated a position in commercial real estate (REITs) in our asset allocation models.

## ■ **Fixed Income**

Federal Reserve support and deleveraging, an improving credit environment, benign inflation, and fiscal weakness in the European Union continued to provide support to the U.S. fixed income market. The Treasury yield curve continued to steepen, signaling a stronger economy and higher real return in the future. Despite the magnitude of spread compression throughout the last several months, we believe the credit sector remains attractive based on the improving economy and the strong demand from investors seeking yield. Therefore, we believe investors should remain overweighted in the credit sector, particularly corporate finance bonds, which we believe are more attractive than industrials. At the same time, we favor overweights to the agency sector, particularly callable bonds and step-up notes, and municipal bonds with attractive quality spreads. We believe investors should continue to underweight Treasury and mortgage securities. The massive amount of federal debt and the corresponding increase in the supply of U.S. Treasuries likely will present longer-term challenges for the Treasury market. We have moved our yield outlook for the 10-year Treasury note modestly upward to a range of 3.5% to 4.5%. While a shift to higher rates in the long term seems clear, the timing and magnitude remain uncertain. Therefore, we believe investors should implement a neutral to slightly short duration strategy relative to their benchmarks. Looking ahead, the soaring federal budget deficit and massive growth of debt, the better relative value in the stock market, and the upcoming conclusion to many of the Fed's temporary securities-purchase programs remain areas of concern for the fixed income market. Yet, bonds remain an attractive hedge against any potential economic weakness.

## ■ **Investment Strategy**

We continued to overweight our overall equity allocation in our balanced and growth models, due to our belief the stock market offers better relative value than the fixed income market. Within our equity allocation, we overweighted U.S. equities and underweighted developed international and emerging market stocks. We underweighted our exposure to fixed income and maintained a strategic weighting to commodities. In addition, we initiated a position in REITs, due to our favorable outlook for the asset class. Historical data indicates that when commercial real estate values fall from their cyclical peaks, REITs initially correct sharply, but then rise sharply as they respond to other market events that are positive for equities as a whole. As commercial real estate prices bottom out, REIT prices continue to appreciate, as they price in a recovery in the values and fundamentals of their underlying portfolios. Also, we expect the volatility of REITs, which has been elevated relative to equities since 2007, to moderate in the near-term as the historical yield/total return relationship is re-established and as REITs continue to deleverage. Currently, the REIT position is underweighted, but we will move toward a full weighting as capital market conditions warrant. The allocation to REITs will result in a pro-rata reduction in the allocation to U.S. Aggregate Fixed Income and International Fixed Income for the Income, Income Primary, Income & Growth, Balanced, and Growth models. For the Aggressive Growth model, the REITs allocation will result in a pro-rata reduction in the allocation to equities.

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