

# Market Monthly

*An analysis of the economy and the markets*

AUGUST 2009

## ■ **The Economy**

The Federal Reserve recently stated “information received suggests that the pace of economic contraction is slowing.” We believe GDP will return to positive territory in the second half of 2009, with the third quarter officially marking the beginning of the next economic expansion. Nevertheless, the strength and sustainability of that recovery still remain uncertain. We believe higher exports and business spending will have to carry the initial stage of the recovery. The likely catalysts to growth include inventory reductions, higher capital expenditures and stable consumer spending. In addition, the slope of the yield curve, recent stock market performance and tighter credit spreads signal a recovery is in order. Housing also showed potentially encouraging signs. The latest reading of the S&P/Case-Shiller Home Price Index indicated home prices in May posted their first month-to-month gain since July 2006. On a year-over-year basis, prices are still lower, but the rate of decline is slowing. Additionally, new and existing home sales have improved. In his recent testimony before Congress, Federal Reserve Chairman Ben Bernanke mentioned for the first time the possible ways the Fed could remove liquidity from the system, including raising the federal funds rate target, selling longer-term securities from the Fed’s portfolio and participating in reverse repurchase agreements. Nevertheless, Bernanke emphasized now is not the appropriate time to take such steps. We believe future Fed tightening is unlikely until late 2010, at the soonest. Long-term economic growth likely will be below historic averages due to the headwinds of deleveraging, higher taxes, increased regulation and the housing overhang. At the same time, a “V-shaped” recovery is not the consensus view, meaning upside surprises remain possible.

## ■ **Equity Markets**

The stock market’s path may be rocky, but we expect it to move on a generally upward trajectory for some time due to the vast improvement in credit markets and expected follow-through in economic activity (i.e., demand deflation). Although the market has bounced mightily off its early-March bottom, it is still sharply lower than last year’s highs, suggesting the Armageddon scenario is no longer priced in, but neither is a significant recovery. As we move out of recession, stocks should outperform bonds. In the U.S., sales volumes and pricing in the housing market are beginning to show some resilience. Higher mortgage rates do threaten a housing recovery, but demand levels generally remain depressed and should improve over time as long as mortgage rates remain lower than 6%. There are several current U.S. government policy initiatives likely to result in unintended economic consequences, including the “cap and trade” energy program, health care overhaul, tax changes and financial-sector reforms. These policies likely will cause the U.S. to import more than it otherwise would and put downward pressure on the dollar. As such, foreign manufacturing centers, such as emerging Asia, China and India, actually may be the primary beneficiaries of these proposed U.S. government policies. If the current health care legislation is meaningfully diluted, it would bode well for health care stocks. In China, fiscal stimulus — which has supported commodities, infrastructure projects and some consumer spending — is causing the nation’s economy to grow at a rapid pace, but it runs the risk of creating a credit bubble. As the economies of the world stabilize, China once again will resume its role as the marginal buyer of most commodities, thereby straining supply and driving up prices. Consequently, we expect emerging markets, commodities, and industrials to perform particularly well over the next three to five years. Add in the eventual risk of inflation due to global monetary stimulus, and commodity-related assets have exceptional appeal. Consumer deleveraging, the mortgage overhang and sub-optimal U.S. economic policy are likely to generate slower-than-normal real economic growth rates, thereby creating a new level of “normal” growth rates. As foreign economies reflate their demand levels and as foreign governments (India, China, Japan, etc.) move toward free market policies, their “new normal” growth rates should accelerate somewhat. Therefore, their currencies should continue to perform better than the U.S. dollar, as the flight to safety of the dollar unwinds and the U.S. grapples with growing budget deficits and massive quantitative easing.

## ■ **Fixed Income**

Once again, the Federal Reserve held the federal funds rate target steady and stated “the Committee expects that inflation will remain subdued for some time.” We agree and expect rates to remain on hold for the balance of 2009-2010, effectively anchoring the short end of the yield curve at a very low level. More important, the Fed began to reduce some of its quantitative easing programs on improving financial market conditions. Treasury yields changed little in July, but corporate borrowing costs continued to fall. Investment-grade spreads tightened by an additional 60 basis points (bps) in the last month, while high-yield spreads narrowed by 115 bps. Investment-grade and high-yield spreads have narrowed by 370 bps and 1160 bps, respectively, from their peaks late last year. Positive corporate earnings announcements have aided the corporate sectors. Volatility, as measured by the Chicago Board Options Exchange VIX index, has fallen from a high earlier this year of 56 to its current level of 25 (volatility and spreads are highly correlated, and a higher index reading means greater volatility). We recommend investors continue to overweight investment-grade corporate bonds. The Fed’s commitment to driving yields lower on higher-quality assets has worked. Spreads on all sectors have tightened dramatically. Therefore, we recommend investors with concentrations in credit sectors re-evaluate their relative positions and pare back large overweight exposures. In particular, we have reduced our agency and FDIC positions to neutral and mortgages to underweight. In addition, the highest-quality municipal bonds are now fairly expensive, while lower-quality bonds remain more attractive. We caution against locking in rates below 2% for any fixed income sector. TIPS have received a lot of attention as a hedge against future inflation, but we still think it is too early to buy them. We still expect inflation to remain benign, which could lead to a lower income stream and a reduced principal value. Nominal Treasury bonds are likely to remain range-bound until a clearer picture on the economy develops. We would be more aggressive buyers of the 10-year Treasury at a yield of approximately 4% and more motivated sellers when the yield approaches 3%. We believe fair value is 3.65%, based on the current level of inflation.

## ■ **Investment Strategy**

We increased the tactical overweight to equities by 500 basis points for our Balanced and Growth portfolios. We believe that the third quarter will officially mark the beginning of the economic expansion. A number of leading indicators have been trending upward over the past several months, pointing toward economic growth. The equity markets have historically posted above-average returns over the six- and 12-month periods after the end of recessions. For our current tactical allocation, we had no exposure to real estate (REITs) and maintained a strategic weighting to commodities.

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