

# Market Monthly

*An analysis of the economy and the markets*

MAY 2010

## ■ **The Economy**

It appears the economy is shifting to a self-sustaining phase, fueled by private job creation, increased consumer spending and inventory rebuilding. In March, the Index of Leading Economic Indicators increased at its fastest pace in 10 months. The March increase marked the 12th-consecutive monthly gain for the index. In addition, the government announced GDP increased at a 3.2% annualized pace in the first quarter of 2010, as consumer spending jumped by the fastest rate in three years. The Federal Reserve's federal funds rate target remained at its historically low range of 0% to 0.25%, which should help support continued economic growth. Similarly, on the global front, interest rates remained low. The core inflation rate (headline inflation minus volatile food and energy prices) continued to help fuel the Fed's easy monetary policy. As of the end of March, the annual rate of core inflation was a subdued 1.1%. Similarly, the Core Personal Consumption Expenditures (PCE) index remained within the Fed's "comfort range" of 1% to 2%. Despite the improving economic data, conditions were not robust enough to influence the unemployment rate, which jumped from 9.7% in March to 9.9% in April, even as employers added 290,000 jobs to the economy. On a positive note, consumer spending has been trending upward for the last several months and consumer confidence improved during April. But, consumer confidence remains fragile in the face of still-high unemployment, the still-weak U.S. housing market and still-tight bank lending standards. Furthermore, mortgage foreclosures have reached record levels, and refinancing activity has plunged. In addition, a soaring budget deficit, geopolitical risks, and the uncertainties surrounding the financial and political implications of the federal government's health care legislation and pending financial sector regulatory changes may present challenges for long-term economic growth. Looking ahead, we expect growth to remain solid for the next few quarters and the unemployment rate to begin to improve. Nevertheless, the headwinds of higher regulation, higher taxes and deleveraging should keep growth from being as robust as it was in past economic recoveries.

## ■ **Equity Market**

The stock market experienced another monthly gain in April, as investors remained optimistic about the economic recovery, improving corporate-sector fundamentals, low domestic interest rates and reasonable stock market valuations. Additionally, with corporate fundamentals improving, mergers-and-acquisitions activity remained poised to accelerate, which may help promote future positive stock market performance. Yet, at the same time, several factors continued to challenge the strength of the economic recovery and the stock market's year-long rally. Specifically, the massive federal budget deficit and the likelihood of higher taxes are creating headwinds for lasting economic growth. Furthermore, the high unemployment rate, continued consumer deleveraging, and tight bank lending standards are providing additional challenges. Meanwhile, political uncertainty continued to haunt investors. In particular, 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. At the same time, investors remain increasingly concerned about the contagion effect from the sovereign debt crises facing Greece and other European nations. Looking ahead, we expect a near-term peak in leading economic indicators may begin a transition period in which market leadership shifts away from the cyclical and higher-beta companies toward those with more stable and defensive characteristics. 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 increased our REIT allocation to each model's long-term (strategic) target.

## ■ **Fixed Income**

The U.S. fixed income market continued to benefit from a stronger U.S. dollar, Federal Reserve support and deleveraging, an improving credit environment and benign inflation. In addition, the mounting fiscal weakness in the European Union prompted a flight to quality, which benefited the U.S. financial markets. The U.S. Treasury yield curve showed additional steepening, signaling a stronger economy and increasing future inflation. In fact, we expect inflation to remain benign in the near term, due to sub-par economic growth. We believe investment-grade credit is now fairly valued, but we expect spreads to remain tight as the economy recovers. Therefore, we recommend a neutral weighting to this sector. For investors with a high risk tolerance, we believe the high-yield market appears attractive. In terms of interest-rate sensitivity, we recommend investors maintain neutral to slightly shorter durations relative to their benchmarks. Although we expect the yield on the 10-year Treasury note to eventually move higher, we believe it's likely to remain lower than 4% in the near term, given the level of global uncertainty. In addition to recommending an overweight to lower-quality corporate bonds (for investors who are comfortable with the risk), we favor callable agency bonds and step-up notes and municipal bonds. We believe underweights to U.S. Treasury and mortgage bonds are warranted at this time, and we believe high-quality corporate bonds currently are expensive. Looking ahead, the soaring federal budget deficit and massive growth of government debt, the better relative value in the stock market, and the upcoming conclusion to many of the Federal Reserve's temporary securities-purchase programs remain areas of concern for the fixed income market. In addition, the sovereign debt crises plaguing Greece and other European nations may threaten the global economic recovery. Yet, U.S. 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 strategic weightings to commodities and alternative strategies. In addition, we increased our REIT (real estate investment trusts) allocation to our long-term (strategic) target, due to our favorable outlook for the asset class. Historical data indicate when commercial real estate values fall from their cyclical peaks, REITs initially correct sharply before rising sharply, as they respond to other market events positive for equities in general. As real estate prices bottom out, REITs continue to rally, pricing in a recovery in the values and fundamentals of their underlying portfolios. We believe the market is now in this latter stage. 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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