

Market Monthly

An analysis of the economy and the markets

DECEMBER 2009

■ *The Economy*

Although the government revised third-quarter GDP downward, from 3.5% to 2.8%, it appears an economic recovery remains underway. The Index of Leading Economic Indicators showed its seventh consecutive monthly gain in November, suggesting economic growth may continue. Additionally, we believe Federal Reserve tightening is unlikely for a while, which should help support economic gains. Housing continues to improve, as demonstrated by the fourth consecutive month-to-month gain in the S&P/Case-Shiller Home Price Index in September and a year-to-date jump in single-family building permits. Furthermore, we believe narrowing credit spreads and improving stock prices continue to signal an improving economy. Inflation remains relatively tame, with the Fed's preferred price gauge, the Core Personal Consumption Expenditures (PCE) Index, staying within the Fed's "comfort range" of 1% to 2%. Despite these positive influences, the strength and sustainability of the recent economic turnaround remain in question. In particular, government stimulus has been the primary driver of recent economic growth, rather than consumer spending, which historically has accounted for approximately 70% of GDP. Consumer spending has declined much more rapidly than income during this recession. But, the combination of pent-up demand and a leveling off in the personal savings rate may allow the consumer to eventually resume some modest spending. Although consumer confidence edged up slightly in November, it remains in the Conference Board's "extremely low" range. Unemployment edged down fractionally in November, but it continues to linger at a 26-year high of 10%. Additionally, the U.S. mortgage foreclosure and delinquency rates continue to increase, and bank lending standards remain tight. Uncertainties surrounding the financial implications for consumers and businesses from government health care reform likely are stifling economic growth. Furthermore, margin improvements at many corporations have been due primarily to cost-cutting rather than top-line growth. Overall, even if the economy can overcome its current challenges, the headwinds of higher government regulation, higher taxes and deleveraging may result in below-average longer-term growth.

■ *Equity Market*

After pulling back in October, stocks resumed their upward path in November, pushing the year-to-date gain for the S&P 500 Index to 24%. Positive trends in the equity markets seem likely to continue, as the economic recession appears to have concluded, leading economic indicators are rising, and the Federal Reserve and other central banks maintain their supportive monetary policies. Overall, stock market valuations appear reasonable, with price/earnings ratios falling in line with longer-term averages. Furthermore, with corporate fundamentals improving, mergers-and-acquisitions activity may be poised to accelerate. Yet, challenges continue to threaten the sustainability of the economic turnaround and the stock market rally. Specifically, the massive federal budget deficit and the likelihood of higher taxes may create headwinds. Much of the improvement in corporate margins has been due to cost-cutting, rather than top-line growth. Furthermore, high unemployment, consumer deleveraging, and tight bank lending standards are creating additional challenges. In addition, several current U.S. government policy initiatives, including the "cap and trade" legislation, health care overhaul, tax changes, and financial-sector reforms, likely will result in unintended economic consequences. Looking ahead, we believe stock market leadership may shift to some of the sectors and stocks that lagged during the recent strong advance. The outperformance of lower-quality companies since the March 2009 market low looks to be ending, as higher-quality companies are in a relatively better position to access capital markets and benefit from overseas demand, a weaker dollar, and attractive relative valuations. We continue to emphasize companies exhibiting attractive financial strength and valuation.

■ *Fixed Income*

The fixed-income market continued to experience steady cash inflows during November. Federal Reserve support and deleveraging, high unemployment, increased consumer saving, and weak economic growth continue to lend support to the fixed-income market. The Treasury yield curve steepened slightly, with yields on two-year Treasuries falling 23 basis points (bps) and yields on 30-year bonds declining three bps. The steep curve signals a stronger economy and increasing (but not rampant) inflation in the future. Currently, inflation remains relatively benign,

lending additional support to the fixed-income market. Investment-grade and high-yield spreads continued to narrow during the month. Positive corporate earnings announcements, lower volatility, and stronger stock performance have aided the corporate sectors. Despite how far spreads have compressed this year, the credit sector remains attractive based on the improving economy and the high demand from investors looking to capture more yield. Thus, we believe investors should remain overweighted in the credit sector. At the same time, we favor overweights to the agency sector, particularly callable bonds and lower-quality municipal securities, and underweights to Treasury and mortgage securities. We expect Treasury rates to gradually rise, now that the Federal Reserve's Treasury purchase program is over, and we therefore believe investors should maintain a neutral to slightly short duration position. We would consider purchasing Treasury securities if the yield on the 10-year Treasury approaches 4%. The 10-year Treasury yield ended November at 3.2%, closer to our "sell" target of 3%. Looking ahead, the massive amount of federal debt and the corresponding increase in the supply of U.S. Treasuries continues to present longer-term challenges for the Treasury market. Additionally, the weak U.S. dollar and the better relative value in the stock market remain concerns for the fixed-income market.

■ **Investment Strategy**

We continued to overweight our overall equity allocation in our balanced and growth models. Within our equity allocation, we overweighted U.S. equities, underweighted developed international stocks, and maintained a strategic weighting to emerging markets. We underweighted our exposure to fixed income and real estate, and we maintained a strategic weighting to commodities. Subdued inflation and the Fed's extremely accommodative monetary policy remain encouraging factors for stocks, and as the economy improves, we expect equities to outperform fixed income.

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