

Market Monthly

An analysis of the economy and the markets

FEBRUARY 2010

■ *The Economy*

The government reported the U.S. economy grew 5.7% in the fourth quarter of 2009, the fastest pace in six years. The Index of Leading Economic Indicators rose for the ninth-consecutive month, pointing toward continued economic growth. In addition, narrowing credit spreads and improving stock prices also suggest the economy is gaining ground. Furthermore, Federal Reserve tightening seems unlikely in 2010, which should help support economic gains. Core inflation (minus volatile food and energy prices) remains relatively tame, with the Core Personal Consumption Expenditures (PCE) index staying within the Fed's "comfort range" of 1% to 2%. On the global front, interest rates seem likely to remain low, and global economies seem poised for synchronized growth. Although we believe the U.S. economy is clearly on a path to stronger growth, we also believe the recent pace of the economic recovery is unsustainable. Government stimulus programs, rather than consumer spending, have accounted for most of the nation's economic growth. Yet, that anomaly may be changing. Consumer spending has been trending upward for the last several months, and consumer confidence hit a 16-month high in January, as more Americans expressed optimism about the economic environment. In addition, several stimulus programs are set to expire this year. At the same time, the unemployment rate remains high and an ongoing threat to economic growth. Additionally, the U.S. housing market continues to show mixed results. Home prices appear to be stabilizing, and single-family building permits and sales have posted modest gains. But, mortgage foreclosures have jumped to record levels, refinancing activity has plunged, and bank lending standards remain tight. In addition, uncertainties surrounding the financial and political implications of government health care reform and other pending regulatory changes may stifle economic growth. Looking ahead, we expect more-modest economic growth, as the impact from government stimulus programs and corporate inventory corrections fade. 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 longer-term growth.

■ *Equity Market*

Although stocks retreated in January, positive trends in the equity markets seem likely to continue. The economic recession appears to have ended, leading economic indicators continue to rise, and corporate fundamentals are improving. Global interest rates remain low, and the Federal Reserve and other central banks are maintaining their supportive monetary policies. Overall, stock market valuations appear reasonable, with price/earnings ratios falling closely in line with longer-term averages. Furthermore, with corporate fundamentals improving, mergers-and-acquisitions activity should accelerate. Yet, challenges 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 may create headwinds. Much of the improvement in corporate margins has been due to cost-cutting, rather than top-line growth. Furthermore, the high unemployment rate, continued consumer deleveraging, and tight bank lending standards are creating additional challenges. In addition, political uncertainty continues to haunt the financial markets, while 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 select sectors and stocks that lagged during last year's strong rally. The outperformance of lower-quality companies after the March 2009 market low seems to have ended, 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*

Federal Reserve support and deleveraging, an improving credit environment, increased consumer saving, benign inflation and the re-appointment of Ben Bernanke as chairman of the Fed provided encouragement to the fixed income market. The Treasury yield curve remained relatively steep, signaling a stronger economy and increasing inflation (but not rampant) in the future. Despite how far spreads have compressed throughout the last several

months, we believe the credit sector remains attractive based on the improving economy and the high demand from investors looking to capture more yield. Therefore, 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 higher-quality municipal securities, and we believe investors should underweight Treasury and mortgage securities. We favor municipal bonds for investors in higher tax brackets, as they look attractive relative to Treasury notes. Municipal quality spreads also offer value. We would consider purchasing Treasury securities if the yield on the 10-year Treasury approaches 4%, and we would favor selling them as the yield approaches 3%. The 10-year Treasury yield ended January at 3.59%. 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 caution against locking in rates lower than 2% for any fixed income sector, because the price risks are asymmetrically tilted toward the downside at these low levels. Looking ahead, the weak U.S. dollar, the soaring federal budget deficit, 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.

■ **Investment Strategy**

We continued to overweight our overall equity allocation in our balanced and growth models. Specifically, we overweighted U.S. equities, underweighted developed international stocks, and maintained a strategic weighting to emerging markets. We are gradually moving toward a new, higher target weighting for emerging markets, from 8% of the total equity weighting to 11%. We underweighted our exposure to fixed income and real estate, and we maintained strategic weightings to commodities and alternative strategies. 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. Emerging markets, as a percentage of the total world equity market capitalization, have been trending upward during the past decade, and we expect this trend to continue. We believe emerging markets offer positive demographics and the potential for higher economic growth relative to the developed markets.

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