Investment Intelligence®

Market Monthly

An analysis of the economy and the markets

BB&T ASSET MANAGEMENT

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The Economy

Despite another downward revision to third-quarter GDP, from 3.5% to 2.8% to 2.2%, an economic recovery appears to be underway. Yet, the recovery's strength and sustainability remain in question. Government stimulus programs, rather than consumer spending, have accounted for most of the nation's economic growth, and consumers seem more intent on saving their money than spending it. Nevertheless, consumer confidence improved in December, as more consumers expressed optimism about the 2010 economic outlook. The Index of Leading Economic Indicators showed its eighth-consecutive monthly gain in December, suggesting economic growth may continue. Narrowing credit spreads and improving stock prices also suggest the economy may be improving. Furthermore, Federal Reserve tightening seems unlikely in 2010, which should help support economic gains. Core inflation (minus volatile food and energy prices) has moderated and 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 the U.S. dollar remains relatively weak compared to other major currencies — a positive factor for U.S.-based multinational companies. The U.S. housing market continues to show mixed results. 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. The steep jobless rate remains among the biggest threats to the economic outlook. Unemployment continued to linger at 10% in December, marking a 26-year high for the U.S. jobless rate. In addition, uncertainties surrounding the financial and political implications of government health care reform may stifle economic growth. 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 threaten longer-term growth.

Equity Market

Stocks continued to advance in December, pushing the one-year gain for the S&P 500 Index to 26%. Positive trends in the equity markets seem likely to continue, as the economic recession appears to have ended, leading economic indicators continue to rise, the U.S. dollar remains relatively weak, and the Federal Reserve and other central banks maintain 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 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, the high unemployment rate, continued consumer deleveraging, and tight bank lending standards are generating 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

High-yield bonds continued to post strong performance during December and finished the year with a gain of 58%. The rest of the market generated modest gains for the year, as indicated by the 6% return for the Barclays Capital U.S. Aggregate Bond Index. Federal Reserve support and deleveraging, high unemployment, increased consumer saving, benign inflation and weak economic growth continue to lend support to the fixed income market. The Treasury yield curve remained relatively steep, signaling a stronger economy and increasing (but not rampant)

inflation in the future. 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, lower quality essential service municipal bonds, and underweights to Treasury and mortgage securities. We would consider purchasing Treasury securities if the yield on the 10-year Treasury approaches 4%. The 10-year Treasury yield ended December at 3.84. 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, the better relative value in the stock market, and the upcoming conclusion to many of the Fed's temporary securities-purchase programs 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 allocations, 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%. 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. 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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