

Market Monthly

An analysis of the economy and the markets

JULY 2009

■ **The Economy**

The Federal Reserve recently stated “information received suggests that the pace of economic contraction is slowing.” We believe the third quarter should officially mark the beginning of the economic expansion, with GDP returning to positive territory for the second half of the year. The likely growth catalysts include the reduced pace of inventory reductions and, surprisingly, the auto industry. The restarting of idle auto plants should have an overall positive impact on GDP. For the most part, growth in the remainder of 2009 will stem from government stimulus, leaving the real question this: Will consumers be able to carry the growth baton once the stimulus runs out? The slope of the yield curve, recent stock market performance and tighter credit spreads all signal a recovery. Furthermore, the U.S. government announced it will allow 10 banks to repay their TARP (Troubled Asset Relief Program) funds. So far, five have repaid their funds — another sign the economic healing process is progressing. We agree the economic climate has improved, but we question the recovery’s potential strength. We also remain concerned about geopolitical risks in North Korea and the Middle East, which continue to threaten the global recovery and commodity prices (particularly oil). Although the U.S. dollar remains under pressure for economic reasons, it remains the global currency of choice. Therefore, if any military action takes place with regard to these hot spots, the U.S. Treasury market and the U.S. dollar would be the likely beneficiaries of a flight to safety. Furthermore, China’s central bank announced it plans to retain its foreign-currency reserve policy, which includes the dollar. Political risk, which has been dormant for many years, has emerged as a formidable force. Long-term growth is likely to slip to below-average levels, due to the headwinds of deleveraging, higher taxes, increased regulation and the housing overhang.

■ **Equity Markets**

Although the Federal Reserve has succeeded in restoring function and form to the credit markets, the world still grapples with the legacy of too much consumer debt, particularly in the United States. Banks continue to deal with rising charge-offs, but a steeper yield curve and improving credit markets are helping to offset the impact. As such, the conditions seem right for the U.S. economy to start recovering, but we remain cautious due to the tug-of-war between aggregate credit expansion and consumer deleveraging. Aggregate velocity measures (such as money supply relative to currency in circulation) have started to flatten but do not yet show increases, indicating banks are content to sit on their capital while they repair their balance sheets. We believe banks will slowly increase their lending in the second half of 2009, but we will monitor this issue closely. The housing market continues to work through its inventory levels. Some markets are healthy, but others still have to work through their excesses. Higher mortgage rates may threaten a housing recovery, but demand levels remain depressed and should improve over time as long as mortgage rates remain below 6%. There are several current policy initiatives that are likely to have unintended economic consequences. The initiatives range from “cap and trade” to health care policy to tax policy to financial reforms. Foreign manufacturing centers, such as emerging Asia, China and India, may actually be the primary beneficiaries of these policies. This will cause the U.S. to import more than it otherwise would and put downward pressure on the dollar. China appears to be “financing its way out of a recession” by forcing its banks to dramatically ramp up lending. This will almost certainly create a credit bubble in China, yet the nation currently is growing its economy at a rapid clip. As various world economies stabilize, China again will resume its role as the marginal buyer of commodities and likely will drive up commodity prices until China meets its own day of reckoning. As foreign economies stabilize, 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. The market has pulled the “Armageddon trade” off the table and is now looking for confirmation of demand reflation. Equity valuations remain reasonably attractive, but the road from here is likely to remain quite rocky due to all the conflicting economic signals.

■ **Fixed Income**

The Treasury yield curve shifted 50 basis points (bps) lower during the past month due to diminished growth prospects and rising unemployment. We do not believe the market can justify much higher rates based on low inflation and the economic headwinds of higher taxes, regulation, and consumer deleveraging that will take place. The Federal Reserve kept rates unchanged again 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 this year and most of next, effectively anchoring short-term rates at a very low level for the next few quarters. More important, the Fed started to reduce some of its quantitative easing programs on signs of improving financial market conditions. After improving through most of June, corporate borrowing costs have stagnated lately. Investment-grade spreads fell an additional 45 bps in the last month (high yield spreads narrowed by 120 bps). Investment-grade and high-yield spreads have narrowed by 300 bps and 1000 bps, respectively, from their widest points of late last year. Volatility, as measured by the Chicago Board Options Exchange VIX index, has fallen from a high of 56 earlier this year to its current level of 24. (Volatility and spreads are highly correlated, and a higher index reading means greater volatility.) Positive corporate earnings announcements, along with the unwinding of the “Armageddon trade” have aided this sector. We suggest investors remain overweighted in investment-grade corporate bonds. The Fed’s commitment to driving down yields on higher-quality assets has worked. Spreads in all sectors have fallen dramatically. Therefore, we recommend investors begin to neutralize some of their bets. Specifically, we have reduced our agency and FDIC positions to neutral and our mortgage exposure to an underweight. In addition, we believe municipal bonds are now fairly valued and appropriate for high-net-worth investors. Although TIPS (Treasury inflation-protected securities) have received considerable attention as a hedge against future inflation, we still think it is too early to purchase them. We expect inflation to decline for a while longer, which likely will lead to a lower income stream and reduced principal value. Treasury bonds likely will remain range bound until economic clarity emerges. 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%.

■ **Investment Strategy**

We maintained our tactical weighting of 60% stocks, 37% fixed income and 3% commodities for our balanced portfolio. The downside risks to the economy have diminished due to an aggressive global policy response, better financial market conditions, and improving leading economic indicators. For our current tactical allocation, we had no exposure in real estate, and we continued to divide the international equity allocation between international EAFE value (6.6%) and international EAFE growth (4.4%). We maintained our allocation to emerging markets equity at 4.8% of the total allocation.

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