Investment Intelligence®

BB&T ASSET MANAGEMENT

Market Monthly

An analysis of the economy and the markets

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The Economy

Consumer spending and personal income continued their upward trends, which helped consumer confidence improve modestly in May. At the same time, though, the government revised first-quarter GDP from an annualized pace of 3.2% to 3.0%, and in April, the Index of Leading Economic Indicators showed its first decline since March 2009. On a positive note, 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. A subdued 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 April, the annual rate of core inflation was 0.9%. Similarly, the Core Personal Consumption Expenditures Index (PCE) remained within the Fed's "comfort range" of 1% to 2%. Despite improving data in certain areas of the economy, the unemployment rate remained stubbornly high, declining slightly from 9.9% to 9.7% on a burst of government hiring of temporary census workers. In the face of still-high unemployment, the still-weak U.S. housing market and still-tight bank lending standards, gains in consumer confidence may prove fragile. Furthermore, mortgage foreclosures have reached record levels, and refinancing activity has plunged. In addition, a soaring budget deficit, geopolitical risks, sovereign debt problems in Europe and regulatory uncertainties may present challenges for long-term economic growth. Looking ahead, it appears the economy has shifted to a self-sustaining phase, fueled by private job creation, albeit weak, increased consumer spending and inventory rebuilding. We expect growth to remain near 3.0% for the next few quarters and the unemployment rate to begin to improve. Nevertheless, the potential headwinds of higher regulation, higher taxes and deleveraging could keep growth from being as robust as it was in past economic recoveries.

Equity Market

The stock market retreated in May, as concerns about the European sovereign debt crisis and its potential contagion effect and impact on the global economic recovery sparked a sell-off. Nevertheless, corporate sector fundamentals and consumer confidence continued to improve, higher-quality companies offered reasonable valuations, and domestic interest rates remained low. Also, 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 threaten the strength of the economic recovery and stock market performance. 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 and growing government regulation continued to worry investors. Also, 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. The recent outperformance of lower-quality stocks should fade if higher market volatility persists. We continue to believe it's important to emphasize companies exhibiting sound financial strength and valuation.

Fixed Income

Most areas of the U.S. fixed income market continued to benefit from a stronger U.S. dollar, Federal Reserve support, consumer and corporate deleveraging, improving corporate balance sheets, and falling inflation. In addition, the mounting fiscal weakness in the European Union prompted a flight to quality, which led to strong monthly results for the U.S. Treasury market. The U.S. Treasury yield curve remained relatively steep, signaling a stronger economy and rising inflation (but not rampant) in the future. 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 tighten as the economy recovers. Therefore, we recommend an overweight 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 believe 10-year Treasury yields are below fair value, we also believe they are likely to remain range-bound (3% to 4%) in the near term, based on global uncertainty. We expect inflation to fall in the next few months and remain benign due to excess capacity and labor, weak housing and lower commodity prices. In addition to recommending an overweight to corporate bonds, we favor callable agency bonds and step-up notes and municipal bonds, with an emphasis on attractive quality spreads and callable securities. We believe underweights to U.S. Treasury and mortgage bonds are warranted at this time. Looking ahead, the soaring federal budget deficit and massive growth of government debt, the better relative value in the stock market, low absolute yields, and regulatory uncertainty remain areas of concern for the fixed income market. In addition, the sovereign debt crises plaguing Greece and other European nations may threaten other developed economies as well as the global economic recovery.

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 over the next 12 to18 months. 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, alternative strategies and REITs.

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