Investment Intelligence®

Market Monthly

An analysis of the economy and the markets

BB&T ASSET MANAGEMENT

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The Economy

Many leading economic indicators continued to show improvement in the last month, suggesting the economy may be on the mend. For example, the stock market appears to have bottomed, credit spreads are narrowing dramatically, and the yield curve is steep. Although first quarter corporate earnings continued to decline, results were better than expected (less negative). Most of the 19 largest banks receiving government bailout funds have been able to raise private capital. The Treasury has announced which banks are eligible to repay their TARP (Troubled Asset Relief Program) funds. We do not expect the housing market to improve until the unemployment rate starts to improve, and that seems unlikely until the end of the year. Still, these factors — housing and employment — are lagging indicators. The financial markets are forward-looking and likely already have discounted additional negative news on housing and unemployment. These indicators probably will get worse before they get better. We are becoming more concerned about geopolitical risks, primarily in North Korea and the Middle East. Political volatility in these regions is threatening the global recovery, commodity prices (primarily oil), and government stability. Although the U.S. dollar remains under pressure for economic reasons, it's still the worldwide currency of choice. Should any military action take place, the U.S. Treasury market and the U.S. dollar likely would be the beneficiaries of a resulting flight to safety. Furthermore, domestic political risk, dormant for many years, has re-emerged, threatening the financial services, health care, energy and industrials sectors. Despite some optimistic signals suggesting the worst of the recession may be over, we remain concerned about recent increases in gas prices, Treasury yields and mortgage rates. Long-term growth may be below historic averages due to the headwinds of deleveraging, higher taxes, increased regulation, and the housing market overhang.

Equity Markets

Recent stock market gains suggest investors are responding to the dramatic improvements in the credit markets. We believe the current rally should no longer be considered a bear market rally, but, at least, a partial recovery. It appears the "reflation" efforts of the Federal Reserve and U.S. Treasury are working. Equity valuations are now discounting some success to the government's all-out efforts. Corporate earnings reports are exceeding analyst estimates, and there are broad signs the credit crisis is easing. Credit spreads are narrowing dramatically, the rate of deceleration in the economy is slowing markedly, commodity prices are increasing, and investors generally are shrugging off bad news. The government's efforts to reduce mortgage rates have helped stabilize the housing market (but the recent rise in mortgage rates is a concern). Demand for homes is improving, while a boost in refinancing activity is lowering monthly expenses and/or reducing economic uncertainty for homeowners. Although the housing market is still fighting a wave of foreclosures, it appears the tenuous path to recovery is improving. The government's reflationary efforts should continue to strengthen the capital positions at financial firms. Nevertheless, lending institutions must continue to improve their reserves, and for this reason, we favor insurers, whose credit losses are more limited, rather than banks, whose credit losses are not as limited. Looking ahead, a stabilization among foreign economies should lead to better performance for foreign currencies relative to the U.S. dollar, as the flight to the safety of the dollar unwinds, the U.S. budget deficit grows, and quantitative easing significantly expands the Federal Reserve's balance sheet. Although a weaker dollar generally is a positive factor for Americans invested overseas, the impact may be offset by President Obama's decision to tax multinational companies at the same tax rate abroad as in the United States. This action will impair the ability of U.S. multinational companies to compete abroad, and the stocks of these companies may struggle if this legislation passes.

Fixed Income

Treasury yields rose in May, as investors' risk appetites continued to improve. Furthermore, concerns about ballooning deficits, massive new issuance, a weaker dollar, and the deteriorating U.S. credit outlook sent Treasury prices falling, which caused yields to increase. Corporate borrowing costs also responded to investor optimism, as investment-grade spreads plunged an additional 80 basis points (bps) and high-yield spreads narrowed by 120 bps during the month. Compared with their peaks late last year, investment-grade and high-yield spreads have narrowed by 260 bps and 900 bps, respectively. Volatility, as measured by the Chicago Board Options Exchange VIX index, has fallen from a high earlier this year of 56 to its current level of 31. (Volatility and corporate spreads are highly correlated, and a higher index reading indicates stronger volatility.) Better-than-expected corporate earnings announcements have helped the corporate bond sector. We suggest overweighting corporate bonds, and for those who are comfortable with a higher degree of risk, we recommend maintaining a small allocation to high-yield bonds. The Federal Reserve's commitment to driving down yields on higher-quality assets has worked, as indicated by the dramatic narrowing of spreads among all sectors. We recommend investors begin neutralizing some of their "bets." In particular, we have reduced our agency and FDIC positions to neutral and our mortgage position to an underweight. In addition, it appears municipal bonds are now fairly valued and make sense for high-net-worth investors. Although TIPS (Treasury inflation-protected securities) have received a lot of attention as a hedge against future inflation, we believe it is still too early to buy them. We expect inflation to decline for a while longer, which likely will lead to reduced TIPS income streams and principal values. A better buying opportunity should emerge later. Treasury yields have increased dramatically since the end of 2008. For example, 10-year Treasury yields have increased from a low of 2.05% to 3.74% in May. As such, we have altered our opinion of Treasury bonds, remaining underweight overall with an eye toward increasing our position when 10-year yields surpass 3.75%.

Investment Strategy

We maintained our weighting of 60% stocks for our balanced portfolio, but we slightly reduced our fixed income exposure to 37% and increased our position in commodities to 3%. The downside risks to the economy have diminished due to an aggressive global policy response, better financial market conditions, and improving leading economic indicators. Historically, broad commodity prices are coincident with economic growth. Our allocation to commodities is now 100% of the strategic (long-term) allocation. We also initiated a position in international small-cap equity. As the global economic recovery continues to gain momentum, we believe higher-beta securities, such as international small-cap stocks, will outperform the broad market. International small-cap stocks also provide better long-term diversification than their large-cap counterparts, as the correlation to U.S. equity is lower for small-cap stocks. For our current tactical allocation, we had no exposure in real estate (REITs), and we continued to divide the international equity allocation between international EAFE value (6.6%) and international EAFE growth (4.4%).

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