

Market Monthly

An analysis of the economy and the markets

MARCH 2010

■ *The Economy*

The government revised fourth quarter economic growth slightly upward to 5.9%, the fastest pace in six years. Meanwhile, the Index of Leading Economic Indicators rose for the 10th-consecutive month, pointing toward continued economic growth. In addition, narrowing credit spreads and improving stock prices also suggest the economy is advancing. The Federal Reserve continued to demonstrate patience, which should keep the federal funds target rate low and help support economic gains. Similarly, on the global front, interest rates seem likely to remain low. Helping to fuel the Fed's patience is core inflation (minus volatile food and energy prices), which remains relatively tame. The Core Personal Consumption Expenditures (PCE) index stayed within the Fed's "comfort range" of 1% to 2%. Nevertheless, despite the improving economy, economic growth is not yet strong enough to lower the unemployment rate, which remained at 9.7%. This high rate of unemployment suggests overall economic conditions are not improving much. Government stimulus programs, rather than consumer spending, have accounted for most of the nation's economic growth. While consumer spending has been trending upward for the last several months, consumer confidence took a nose dive in February, as Americans expressed concerns about the jobs climate and the sustainability of the economic recovery. In addition, several stimulus programs are set to expire this year, putting further pressure on recent economic gains. Additionally, the U.S. housing market continued to show mixed results. Home prices appear to be stabilizing, but home sales tumbled sharply in February, mortgage foreclosures jumped to record levels, refinancing activity plunged, and bank lending standards remained tight. In addition, uncertainties surrounding the financial and political implications of government health care reform and other pending regulatory changes may stifle future 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 growth for the next few years.

■ *Equity Market*

After retreating in January, stocks rebounded in February to post modest gains for the month. In general, the economic news remained favorable. Fourth quarter 2009 economic growth was slightly better than originally reported (+5.9% vs. +5.7%), leading economic indicators continued to rise, and corporate fundamentals improved, even showing pockets of top-line growth. On the rate front, 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 increase. Stock market performance also may benefit from the significant liquidity still remaining on the sidelines. Yet, at the same time, investors cannot ignore several lingering factors that may threaten the sustainability of the economic turnaround and stock market performance. Specifically, the massive federal budget deficit and the likelihood of higher taxes are creating headwinds for lasting economic growth. Additionally, 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. Meanwhile, political uncertainty continues to haunt the financial markets. Specifically, 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 and attractive relative valuations. We continue to believe it's important to emphasize companies exhibiting attractive financial strength and valuation. It's also important to note REITs (real estate investment trusts) have raised significant amounts of capital during the past year. Their access to public capital has provided them with a distinct advantage in the current commercial real estate market. We have not yet initiated a position in commercial real estate (REITs) in our asset allocation models.

■ **Fixed Income**

Federal Reserve support and deleveraging, an improving credit environment, increased consumer saving, benign core inflation, and fiscal weakness in the European Union continued to provide encouragement to the U.S. fixed income market. The Treasury yield curve remained relatively steep, signaling a stronger economy and rising 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, particularly corporate finance bonds, which we believe are more attractive than industrials. 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, even though relative valuation has moved closer to the longer term average. Taxes are going up, and historical ratios likely will fall. Municipal quality spreads also remain attractive. 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. While a shift to higher rates in the long term seems clear, the timing and magnitude remain uncertain. Therefore, we believe investors should implement a neutral to slightly short duration strategy relative to their benchmarks. Looking ahead, a weaker U.S. dollar in the long term, 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. On the other hand, bonds remain an attractive hedge against any potential economic weakness.

■ **Investment Strategy**

We continued to overweight our overall equity allocation in our balanced and growth models. Within our equity allocation, 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 strategic weightings to commodities and alternative strategies. We have not yet initiated a position in REITs. 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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