Investment Intelligence®

BB&T ASSET MANAGEMENT

Market Monthly

An analysis of the economy and the markets

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The Economy

Last month the government reported third-quarter GDP was 3.5%, the first positive reading in more than a year and technically marking the end of the recession. Overall, the economic-growth report was positive, but it didn't demonstrate the typical "boom" coming out of a nasty downturn. For example, 0.9% of the GDP figure was due to the government's now-expired "cash for clunkers" program, and 1% came from a change in inventories. Still, we believe narrowing credit spreads and improving stock prices continue to signal an improving economy. Additionally, the Federal Reserve stated "economic activity has continued to pick up," and "household spending appears to be expanding but remains constrained by ongoing job losses." Also, the Fed's completion of its Treasury purchase program offers another indication the overall financial backdrop is healing. But, at the same time, the Fed extended other programs, including its agency mortgage purchase program to March 2010 and the Term Asset-Backed Securities Loan Facility (aimed at supporting commercial real estate) to June 2010. Therefore, we believe Fed tightening is unlikely for a while. Housing continues to improve, as demonstrated by the third consecutive month-to-month gain in the S&P/Case-Shiller Home Price Index in August. Furthermore, the home inventory glut is shrinking, and the federal government's decision to extend the new home tax credit until April 2010 should continue to help the housing industry. Clearly, the real indicator of a once-again healthy economy is consumer spending. When consumer spending starts expanding and the economy becomes less-reliant on government stimulus for growth, we should be out of the recession woods. But, consumer spending most likely won't improve until the unemployment rate starts falling, which is unlikely until sometime next year. Even with the return of consumer-spending growth, the headwinds of deleveraging, higher taxes, increased regulation and the housing overhang likely will foster below-average long-term economic growth. In addition, the recent housing market meltdown has turned many Americans back into savers, much like the Great Depression did more than 70 years ago. This shift in behavior (temporary or, as we believe, more permanent) will have a profound impact on the type of recovery that emerges.

Equity Market

We expect the equity market's positive trends to continue, despite the inevitable risk of a correction. The market's breadth likely will narrow, as investors differentiate companies with pricing power, cost advantages and access to capital. We continue to see signs of demand "reflation," as a wide variety of indicators are pointing toward growth. Given how sharply many firms have reduced their costs during the past year, corporations should be able to ramp up their profits meaningfully in the near term. In general, company fundamentals are improving, and Fed policy remains extremely accommodative. Improving credit market conditions should help spark corporate consolidations and/or stock repurchases. We're concerned about the longer-term performance of the U.S. economy, but the near-term outlook appears positive, and we will monitor shorter-term Treasury bond yields for any indication this trend is changing. We expect the Fed to remain on hold for a while. Consumer deleveraging, the housing market overhang and sub-optimal U.S. economic policy suggest real economic growth in the United States will be slower than average. On the other hand, as foreign economies "reflate" their demand levels, and as foreign governments, such as India, China and Japan, move toward free-market policies, their new "normal" growth rates should accelerate. Therefore, select foreign 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. In addition, there are several current U.S. government policy initiatives likely to result in unintended economic consequences, including the "cap and trade" energy program, health care overhaul, tax changes and financial-sector reforms. These policies likely will cause the U.S. to import more than it otherwise would and put downward pressure on the dollar. Foreign manufacturing centers, such as emerging Asia, China and India, actually may be the primary beneficiaries of these proposed U.S. government policies. On a positive note, if the current health care legislation is meaningfully diluted, health care stocks should perform well. In China, fiscal stimulus — which has supported commodities, infrastructure projects and some consumer spending — is causing the nation's economy to grow at a rapid pace. But this fast growth runs the risk of creating a credit bubble. As the economies of the world stabilize, China once again

will resume its role as the marginal buyer of most commodities, thereby straining supply and driving up prices. Consequently, we expect emerging market, commodity and industrial stocks to perform particularly well over the next three to five years. In addition, factor in the eventual risk of inflation due to global monetary stimulus, and we believe commodity-related assets have exceptional appeal.

Fixed Income

Money continues to flow into bond funds as investors skeptical about the stock market continue to seek returns higher than the near-zero levels offered by most money market products. This flow of cash should continue to support further spread tightening and keep interest rates low. The Treasury yield curve steepened in October, with yields on two-year Treasuries falling six basis points (bps) and yields on 30-year bonds increasing 18 bps. Investment-grade spreads narrowed by an additional 12 bps during October, while high-yield spreads tightened another 29 bps. Positive corporate earnings announcements, lower volatility and stronger stock performance have aided the corporate sectors. Despite the significant amount of spread tightening so far this year, the credit sectors remain attractive based on the improving economy and strong demand from investors looking to capture more yield. We believe investors should remain overweight in this sector. At the same time, we favor an overweight to the agency sector, particularly callable bonds, and underweights to Treasury and mortgage securities. On a relative basis, municipal bonds appear to offer attractive value. We caution against locking in rates below 2% for any fixed-income sector, as the price risks are asymmetrically tilted toward the downside at these low levels. Ten-year Treasury bonds are yielding approximately 3.5%, right in the middle of the 3% to 4% range they have been stuck in since April. We expect Treasury rates to gradually rise, now that the Fed's Treasury purchase program is over, and we therefore believe clients should maintain a slightly-short duration position. The 10-year breakeven — or the yield difference between 10-year nominal Treasuries and 10-year TIPS (Treasury inflation-protected securities) — is 2.1 percentage points. The 10-year breakeven rate is a measure of the market's inflation expectations for the next 10 years, meaning inflation must be higher than that for TIPS to outperform nominal Treasuries. In addition, on an interim basis the real return premium for TIPS is only 1.4%. We believe this rate should be at least 2.5% on a long-term basis. For these reasons, we do not recommend purchasing TIPS at this time. Overall, we believe investors should consider reducing their more-aggressive overweights. In the second and third quarters, strong gains were the norm, and preserving those gains should be a priority.

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 international stocks, and maintained a strategic weighting to emerging 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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