

Market Monthly

An analysis of the economy and the markets

OCTOBER 2009

■ *The Economy*

September marked the fifth consecutive month in which leading economic indicators, including stock prices, credit spreads and the Treasury yield curve were positive. In particular, this year's stock rally, narrowing credit spreads and the steepening Treasury yield curve fuel our argument that the economy is in the midst of a recovery. In addition, the closely-watched housing sector may be on the verge of a turnaround. The S&P/Case-Shiller Home Price Index posted its third consecutive month-to-month gain in July, and new and existing home sales have improved. On a year-over-year basis, home prices are still lower, but the pace of the decline is slowing. Furthermore, the government revised upward its final report on second quarter GDP, from -1.0% to -0.7%, suggesting the economy was on firmer ground than originally thought. Even the Federal Reserve acknowledged the improvements, stating "economic activity has picked up following its severe downturn." The Fed extended its mortgage purchase program to March 2010 and its Term Asset-Backed Securities Loan Facility, aimed at supporting commercial real estate, to June 2010. We believe future Fed tightening is unlikely until these and other Fed programs have expired. Despite the data suggesting an economic rebound may be underway, the strength and sustainability of the recovery remain questionable. 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 into savers again, much like the Great Depression did more than 70 years ago. This shift in behavior (temporary or more permanent, as we believe) will have a profound impact on the type of recovery that emerges. Given the subdued nature of consumer spending, we believe higher exports and government and business spending are necessary for the economic recovery to persist.

■ *Equity Markets*

We continue to see signs of demand "reflation," as a wide variety of indicators are pointing toward improvement. The equity markets are exhibiting accelerating growth, liquidity is growing, and Federal Reserve policy remains accommodative. Improving credit market conditions should help spark corporate consolidations and/or stock repurchase. Furthermore, given how sharply many firms reduced their costs during the past year, they should be able to ramp up profits meaningfully in the near term. Therefore, we expect the positive trends in the stock market to continue, despite the inevitable risk of a correction. We worry 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 continued to pour into bonds funds at a record pace, which should continue to support further spread tightening and keep interest rates low. Treasury yields declined by approximately 10 basis points in September, and high-quality corporate borrowing costs hit new lows for this cycle. Investment-grade spreads fell an additional 10 basis points, while high-yield spreads tightened another 90 basis points. Despite the significant spread tightening so far this year, spreads still remain wider than historical averages. While positive corporate earnings announcements have aided the corporate sectors, recent higher volatility has been a performance detractor. Nevertheless, the massive cash inflows should continue to benefit this sector, and fundamentals are still improving. We believe investors should remain overweighted in the credit sectors for the near term. 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 better value than Treasuries. 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. We believe fair value for the 10-year Treasury bond is 3.65%, given current inflation expectations, and we therefore recommend a slightly defensive duration target. The next 50-basis-point-move likely will be a shift higher than lower. Although TIPS (Treasury inflation-protected securities) have received attention as a reliable hedge against future inflation, we still think it's too early to buy them. We continue to expect inflation to remain benign, which could lead to a lower income stream and reduced principal value for TIPS. Overall, we believe investors should consider shifting from a more aggressive fixed income outlook to a more cautious stance. 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 fixed income and real estate exposure, 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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