

Market Monthly

An analysis of the economy and the markets

JANUARY 2008

■ *The Economy*

Since its FOMC meeting on September 18, 2007, the Federal Reserve has cut interest rates by 100 basis points. We expect further rate cuts in response to continued economic weakness. Although we still believe the U.S. economy will avert a recession, the likelihood of a hard landing clearly has increased. Despite the Fed's commitment to respond to continued financial-market turbulence, their current posture seems more reactionary than proactive. As such, the risk of them falling further behind is increasing. For example, the most recent ISM Manufacturing report fell from 50.8 to 47.7. More significant, the housing market's ongoing slump and the related impact on consumers continue to impede economic growth. According to the S&P/Case-Shiller Home Price Index, prices were down 6.1% last year, and they continue to fall at an accelerating pace. Ultimately, prices could fall 10% or more by the time the market bottoms. Yet, despite all the negative headlines, much of the housing pain is concentrated in Florida, California, Arizona, Nevada and the Northeast, where home prices had exploded in recent years. We expect 2008 to be another difficult year for the housing market, but the drag on economic growth should ease by year end. At the earliest, housing may have a positive impact on economic growth in 2009. Jobless claims are a critical indicator of the economy's health, and although they have risen recently, we believe the jobless rate is not a threat to the economy. As long as jobs are available, the economy likely will avoid a recession. Therefore, we will watch the jobs data closely throughout the next few months. On the inflation front, we remain constructive. Financial crises historically have led to lower inflation, and we expect this "crisis" will be no different. We disagree with those calling for "stagflation." Simply put, slower growth leads to lower inflation and lower interest rates. We should not be fooled by elevated oil prices, which have more to do with the weak U.S. dollar (oil is traded in dollar terms) than an inflation indicator. Furthermore, the owner's equivalent rent comprises 40% of the inflation data. And, given the current state of the housing market, we expect this component to help stifle inflation.

■ *Equity Markets*

The credit crunch still is clouding economic growth, as credit spreads continue to widen, asset-backed commercial paper continues to struggle, and the ongoing subprime debacle continues to block transparency. Several private equity and hedge funds have created distressed investment vehicles to purchase mortgage assets, but few of them are buying subprime assets. As long as the Federal Reserve remains behind the curve, the risk to economic growth remains severe. With the economy weakening, it's crucial for the Fed to become more proactive in resolving the crisis. If the Fed can keep the economy out of a recession, long-term earnings growth should remain healthy. Nevertheless, near-term earnings results appear to be at risk for all but the global, multinational companies, which continue to benefit from a falling U.S. dollar and global economic strength. With reasonably healthy balance sheets and strong free-cash-flow, corporations still have the flexibility to pursue shareholder-friendly actions, including raising dividends, repurchasing shares and, pending the resolution of the liquidity crunch, making accretive acquisitions. Consumer spending has slowed due to several headwinds, including high energy prices, low housing affordability, a weak housing market and tighter lending standards. Spending on the business side has slipped recently, but the falling U.S. dollar has provided a lift to U.S. exports. The U.S. trade deficit, relatively slower economy, and the shrinking short-term interest rate differential for the United States relative to the rest of the developed world continue to put downward pressure on the dollar. This scenario should continue to benefit multinational companies on a relative basis, assuming the weakening remains orderly. On a cautionary note, Congress and several presidential candidates have been promoting a populist agenda. Recent trade disputes with China may reflect a growing protectionist view in Washington, D.C. Any tariffs resulting from this view may trigger higher domestic inflation, so we will closely monitor trade policy and Congressional action.

■ **Fixed Income**

The credit markets appear to be stabilizing, as witnessed by Libor rates following the federal funds rates lower. We expect weak economic growth in 2008, with a significant chance of a hard landing. Treasury market pricing suggests investors are convinced the economy is going to fall into a recession. Fear continues to drive the aggressive Treasury demand and has pushed U.S. Treasury yields lower than their global counterparts. The weak dollar and lower absolute yields should limit fundamental demand. Investment-grade corporate bond spreads appear to have stabilized around +200 basis points above Treasuries. As such, we would call for a neutral or market weight in this sector. Breakeven spreads are 30 basis points (the average has been 10 basis points throughout the last decade), which means spreads have to widen an additional 30 basis points each year before they underperform Treasuries. We think the odds have shifted to the buyer's favor. In the tax-exempt market, municipal bond valuations remain attractive, with most bonds inside 10 years trading at approximately 90% of Treasury yields. Investors continue to enjoy the lower volatility and safety of the municipal market in these uncertain times. Furthermore, with elections looming, the increased odds of higher marginal tax rates remain a strong selling point for tax-free bonds. In terms of interest-rate exposure, we currently recommend neutral portfolio durations. We also recommend maintaining overweights to agency, municipal and mortgage-backed bonds. We suggest underweighting Treasuries, because yields already reflect a recession and an anticipated fed funds rate target of 2.5%. At this point, we do not believe either is likely to occur. Indeed, investor emotions ultimately could push rates even lower, but we do not believe there is enough fundamental weakness to justify these rates for the long-term. Several bond insurers remain under pressure due to losses in the mortgage and CDO markets. For example, ACA was downgraded from A to CCC and is in jeopardy of going out of business. Warren Buffett recently announced he will form a municipal reinsurance company. The AAA ratings for MBIA, Ambac, CIFG, XLCA, and FGIC are in question, unless they raise additional capital. We expect these insurers will do what is necessary to maintain their ratings, but these problems reinforce our belief that bonds should be purchased based on the underlying quality rating and not just based on insurance.

■ **Investment Strategy**

We have shifted from a tactical asset allocation of 65% stocks/35% bonds to our long-term target allocation of 60% stocks/40% bonds for our balanced portfolio. We remain cautiously optimistic with regard to stocks, given their reasonable valuations and relatively healthy balance sheets, combined with low bond yields and an easing Federal Reserve. Nevertheless, we believe it is appropriate to be at our long-term target equity weighting at this point, due to the Fed's lagging response to the financial and economic problems, current economic uncertainty, and high earnings expectations. We continue to focus on higher-quality securities, particularly the stocks of financially strong companies with reasonable earnings-growth prospects.

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