

Market Monthly

An analysis of the economy and the markets

JANUARY 17, 2007

■ *The Economy*

After growing by 2.6% in the second quarter of 2006, economic growth for the third quarter was revised slightly downward, from 2.2% to 2.0%, in December. This provides further evidence the economy is in a mid-cycle slowdown. Federal Reserve Chairman Ben Bernanke continues to focus on inflationary pressures and whether or not the Fed needs to tighten further. In fact, inflation measures continue to retreat. The Fed's preferred measure of inflation, the Core Personal Consumption Expenditures (PCE) Index, stands at 2.2%, after peaking at 2.5%. The PCE deflator is 1.9%, and the Institute for Supply Management's prices-paid index has dropped from 75 to 48. The Purchaser Price Index is 0.9% (year over year), and the Consumer Price Index is 2.0%. Despite the recent firming in energy prices and other commodities, secular disinflation remains the dominant trend. Bernanke and others also believe the housing market has bottomed. We disagree. We believe the housing market correction will play an even larger role in the economy going forward, keeping the growth rate below its potential of approximately 3.0% for the next several quarters. Historically, significant slowdowns in consumer spending have accompanied real estate downturns. We don't see any reason why this housing market downturn will be any different. As of December 29, 2006, the Blue Chip Forecast calls for real GDP of 2.5% to 3.5% for 2007 and for the 10-year Treasury yield to rise from 4.71% to 5.10%. Our economic outlook is less optimistic. We expect an economic growth rate of 2% to 3%, and we expect the 10-year Treasury yield to decline slightly, to approximately 4.50%. Since 1960 there have been only two periods (1967 and 1995) when housing and economic recessions did not occur in tandem. The key during each of these periods was unemployment, which never increased. Therefore, we will closely monitor the number of jobless claims and the change in non-farm payrolls, which, to date, have been supportive.

■ *Equity Markets*

A backdrop of slowing economic growth, contained inflation, relatively low long-term interest rates, and reasonable large-cap valuation levels continued to support stock market gains. In addition, the continuation of the Federal Reserve's pause in its rate-tightening campaign provided ongoing support for higher stock prices. Positive corporate fundamentals also remained an influence. In particular, healthy balance sheets and strong free cash flows continued to give corporations the flexibility to initiate various shareholder-friendly actions, including increased dividend payments, share buybacks and strategic acquisitions. Heightened mergers-and-acquisitions activity, including private equity deals, continues to validate our position that stocks in general are relatively cheap. What's more, we believe the equity market has additional upside potential. The large U.S. trade deficit, combined with a shrinking short-term interest rate differential for the United States relative to the rest of the developed world, should continue to put downward pressure on the dollar. This should benefit multi-national (large-cap) companies on a relative basis, assuming the dollar's weakening is orderly. Although earnings growth is moderating, it remains healthy. Nevertheless, market multiples should expand, with lower interest rates (including the prospect of a Fed easing in 2007) offsetting the slower pace of earnings growth. We continue to expect business spending to fare better than consumer spending, but the net effect may be negative. The U.S. consumer, the cornerstone of the global expansion, continues to face significant headwinds, including high energy prices, low housing affordability and a weak housing market.

■ **Fixed Income**

The December sell-off in the Treasury market, including the 30-basis-point increase in the 10-year Treasury yield, appears to be a normal correction after a tremendous five-month rally in which yields declined by 75 basis points. Our proprietary bond model suggests fair value on the 10-year Treasury yield is approximately 4.60%, slightly lower than its year-end yield of 4.71%. Given the recent falloff in inflation measures and our belief this trend will continue, our bias remains toward lower rates. Continued weak economic data, lower inflation and, eventually, a cooperative Federal Reserve should prolong the bond market rally. We expect short-term rates (five years and less) to be the major beneficiary of the rally's next stage. The Fed has a direct impact on such rates, and as interest rate policy potentially eases, we should see the yield curve steepen. This steepening should occur with short-term rates falling, as opposed to longer-term rates rising. Although we expect the curve to return to its "normal," upward-sloping shape in 2007, we believe it will remain much flatter than usual for a prolonged period. We maintain our preference for interest rate risk over credit risk — or for mortgages and callable agencies over corporate bonds. We believe the market may be in a prolonged range-bound period, and the best way to outperform in such a market may be to emphasize income. In fact, more than 80% of bond returns come from the income component. We believe investors should structure their fixed income portfolios with a built-in income advantage over the respective benchmark by overweighting spread product, including mortgage and agency securities. In addition, we recommend investors maintain a slightly longer-than-benchmark duration, or interest-rate risk. Practicing such strategies may help investors achieve a safe, steady and predictable income stream with limited risk.

■ **Investment Strategy**

We continue to recommend a tactical asset allocation of 65% stocks/35% bonds. This allocation reflects our belief that longer-term market conditions should favor stocks over bonds. Slower economic growth, a reduction in inflationary pressures, relatively low long-term interest rates, and reasonable stock valuations provide a favorable backdrop for equities. Within the stock market, we continue to favor higher-quality securities, particularly the stocks of financially strong companies with reasonable earnings growth prospects. Specifically, we continue to overweight large-cap stocks, due to their attractive valuations and the desire to maintain a more-defensive equity exposure.

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