BB&T ASSET MANAGEMENT

Investment Intelligence®

Market Monthly

An analysis of the economy and the markets

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The Economy

After exhibiting solid growth throughout 2005, we expect the U.S. economy to experience a mid-cycle slowdown in 2006, led by a modest consumer retrenchment. Higher energy prices, a stronger dollar, higher interest and mortgage rates, and the lowest level of housing affordability since 1991 may take a toll on consumer spending. But the leadership role in generating positive economic growth should shift to the cash-rich business sector. We believe the economic data will support a pause in rates, and the Federal Reserve will make its final rate hike of the current cycle at its January meeting, pushing the federal funds rate to 4.50%. It appears as though the Fed is achieving its goal of slowing down U.S. economic activity, including the housing market. At its final meeting of 2005, the Fed indicated that the Fed Funds target rate was no longer "accommodative" to economic growth. Indeed, the Fed already may be in the overshoot phase, as banks have tightened their lending standards, housing delinquencies have increased, and the yield curve is inverted. Beyond the January meeting (which is retiring Chairman Alan Greenspan's last), the Fed's action is unclear, as trends in economic and inflation data will drive policy. Ben Bernanke assumes his role as Federal Reserve chairman February 1, and the market clearly anticipates a smooth transition. Under Bernanke's leadership, the Fed likely will become more transparent based on his favorable view toward inflation targeting. This could reduce long-term volatility by providing a known foundation for Fed activity. The current cycle reminds us of events in 1994-95, and while the risks to a "soft landing" increase with each successive rate hike, we expect a similar soft landing in 2006.

Equity Markets

All equity styles generated positive returns during 2005, with international and mid-cap stocks posting the best performance. And most signs point to continued strength in 2006. Economic growth, relatively contained inflation, low long-term interest rates, and reasonable stock valuations all provide a favorable backdrop for stocks in the new year. Although decelerating, corporate earnings growth continues, with growth estimates of approximately 7% for 2006, down from 11% for 2005. With earnings growth outpacing price appreciation in 2005, the market's price-to-earnings (P/E) ratio has retreated to more attractive levels. In terms of valuation, the stock market, as measured by the S&P 500 Index, currently is trading at an attractive 15.5-times earnings, leaving room for potentially significant expansion. In particular, companies with high returns on equity (ROE) and good organic growth should benefit from multiple expansion. In addition, we expect the U.S. dollar to weaken. Prior to 2005, the U.S. dollar was in a multi-year downward trend, and we believe that trend should resume in 2006, primarily due to the large and growing 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. This should bode well for the stock prices of large, multinational companies. Despite all the positive influences on stocks, there are some near-term concerns. For example, higher short-term interest rates and commodity prices are putting pressure on corporate profit margins, currently near record levels. In addition, higher

interest rates, high energy prices, a reduction in housing affordability, and a peaking housing market likely will put pressure on the consumer-driven component of economic growth. Furthermore, previous periods of Fed tightening have often triggered some type of financial "crisis," and we have yet to see such a problem in this Fed cycle. Overall, the current environment is a good one for equity investors.

Bond Markets

Bond yields increased in an inverted fashion during 2005, with the two-year Treasury up 133 basis points, the five-year Treasury up 74 basis points and the 10-year Treasury up 17 basis points. The yield on the 30-year Treasury declined 29 basis points for the one-year period. It appears that interest rates have peaked for this cycle, and the worst fears of bondholders are behind us. The two- to 10-year portion of the yield curve remains inverted, which confirms our belief that the Fed has achieved its objectives. Further evidence suggests the Fed has succeeded in slowing growth and keeping inflation at benign levels, and we expect interest rates to fall during the next six to 12 months as the economy begins to cool off. In such a climate, longer-duration strategies may outperform. We believe the yield curve's inversion should unwind slowly during 2006. Whereas the rate environment of 2005 warranted a barbell maturity structure (emphasis on the short and long ends of the curve), the anticipated climate for 2006 requires a more "bullish" strategy. For example, we favor a laddered strategy of evenly distributing assets across the four- to 10-year portion of the yield curve. We recommend bonds with good call protection, which should perform better in a falling-rate environment. The mortgage sector remains our favorite, due to attractive spreads. Specifically, we favor current coupon and slightly discounted bonds, which should outperform in a falling-rate environment. We also suggest a market weight of government bond exposure to guard against a financial crisis — but more important, to benefit from the expected slowing economy. In addition, municipal bonds are attractively valued and continue to benefit from positive seasonal supply/demand factors. We continue to recommend an underweight in corporate bonds due to high valuations and more aggressive, shareholder-friendly activities dominating management decisions.

Investment Strategy

We begin 2006 with a change in our tactical asset allocation in favor of stocks. We shifted our recommended allocation from 60% stocks/40% bonds to 65% stocks/35% bonds, reflecting our belief that stocks will outperform bonds throughout 2006. Overall stock valuations, represented by the market's forward-looking P/E ratio, are low by historical standards. In addition, we believe the Fed's strategy of tightening monetary policy gradually and with such transparency mitigates the risk of a financial crisis on the horizon. Furthermore, we anticipate strong earnings growth from companies that benefit from business spending and those with significant international exposure.

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