Investment Intelligence®

Market Monthly

An analysis of the economy and the markets

BB&T ASSET MANAGEMENT

FEBRUARY 2009

The Economy

It now appears economic data in the first quarter of 2009 may be worse than the economic figures reported for the fourth quarter of 2008, which many had thought was the bottom of the recession. Inventory building and lower import/export activity helped fourth quarter GDP decline only 3.8%, compared with the consensus expectation of -5.5%. Layoffs continue to mount, and investors and corporations continue to reduce their earnings expectations. So far, 2009 is shaping up to be a difficult year, considering two legs of the economic stool are broken: businesses and consumers have drastically curtailed their spending, along with just part of the third leg — local governments. It's only the other half — the federal government — that has increased spending. In particular, Treasury Secretary Tim Geithner pledged up to $2 trillion in government financing to spur new lending and address banks' toxic assets. His two main proposals include forming a $1 trillion joint public/private partnership to buy illiquid assets and targeting another $1 trillion to new credit for consumers and businesses. However, in the absence of further details from Secretary Geithner, the stock market responded negatively to these proposals.

From an international perspective, there remains a disparity between the European Central Bank (ECB) and the Federal Reserve. The ECB is reluctant to cut interest rates below 2%, while the Fed has targeted rates between 0% and 0.25%. We still believe the ECB is misjudging inflation risks, and by holding to a 2% rate target, it risks pushing the Eurozone countries into a deeper recession. The financial crisis and deleveraging process are, by nature, deflationary. Additionally, commodity prices such as oil, nickel, copper, and corn have fallen dramatically from their highs. Wages remain under pressure, and home prices continue to soften. All of these factors have helped and will continue to help drive down headline inflation. The core Personal Consumption Expenditures (PCE) index is only 1.7% and is falling. The Fed's stated target for this measure is 1% to 2%. In addition to the favorable inflation news, credit spreads are starting to recede, mortgage refinancing is booming due to plunging rates, and falling gas prices mean consumers have more discretionary money to keep. Additionally, more government stimulus is in the works, and historically low savings interest rates likely will encourage investment. The question is, though: When will these positive factors start to influence growth? We believe growth should improve in late 2009 or early 2010.

Equity Markets

Recent corporate financial reports confirm a severe global recession is underway. We remain particularly concerned about corporations with high fixed costs and operating leverage. Across the board, companies are engaged in a massive wave of layoffs and downsizing to adjust to lower demand. Furthermore, consumer spending continues to deteriorate, as consumers radically reshape their purchasing behavior and shrink their budgets. These changes are affecting restaurants, consumer products companies, and retailers. The new Obama administration is attempting to give the economy a jolt with a massive stimulus plan aimed at jobs, housing and credit. We have mixed views, considering the proposed plan offers substance saddled with "pork." In particular, we believe stabilizing home prices and the overall housing market requires a stemming of the foreclosure rate, and we are pleased the government is dedicating some of the leftover TARP (Troubled Asset Relief Program) money toward this end. Despite this effort, the combination of falling home prices and relatively low mortgage rates is pushing home affordability to attractive levels on its own, prompting increased demand for homes and improvements in home inventory levels. Home prices currently are on track to stabilize within the next 12 months or so. Such stabilization is an important milestone, as many toxic assets then would be priced at some salvage value, which in turn should strengthen liquidity in the banking system.

European economies have deteriorated sharply. The credit crisis is intensifying in Europe, which has led to relative strength for the U.S. dollar. Nevertheless, international economies at some point will bottom, and their currencies should stabilize. Indeed, shifting consumer behavior has helped reduce the U.S. trade deficit, but the deficit itself should continue into the foreseeable future. Therefore, we expect the dollar to resume a weakening trend after other markets stabilize. No country wants a strong currency in this environment, so this dynamic is encouraging countries to print money. We are watching these developments closely. Overall, equity valuations largely discount a worst-case

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scenario, implying a low probability of success to the all-out efforts of the Federal Reserve and U.S. Treasury. We think the “re-flation” efforts eventually will work, and we are maintaining our long-term strategic equity weighting across all portfolios.

Fixed Income

The Treasury yield curve experienced a “bear steepener” in January, reversing some of the impact of the fourth quarter’s flight to quality. Two-year Treasury yields increased 18 basis points (bps), while 10- and 30-year yields increased 63 bps and 93 bps, respectively. In a change from recent trends, Treasury bonds were the month’s worst performers, and municipal bonds were the top performers. Despite January’s increase in Treasury yields (and corresponding decline in prices), Treasuries remain well below their levels of last October, and we continue to recommend investors underweight the sector. Spreads on investment-grade corporate bonds continue to improve and now have fallen 140 bps from their peak of 620 bps. Similarly, high-yield spreads have narrowed to 14.3% from their high of nearly 20%. The Chicago Board Options Exchange Volatility Index (VIX), a widely used measure of market risk, has moved back up to the upper 40s (versus a high of 80 and a recent low of 40; a higher number indicates greater volatility) and warrants close monitoring. Historically, lower volatility has been strongly correlated to lower quality spreads, so the recent divergence is a concern. Nevertheless, it appears the worst may be over and better times may be ahead for credit investors. Corporate borrowing costs are within the sights of the Federal Reserve, and if the market does not heal this sector on its own, we expect the Fed will buy investment-grade corporate bonds directly to reduce borrowing costs for corporate America. High-quality companies have been able to borrow, and the credit markets are now beginning to function better, but they are still far from normal. The Fed is committed to driving yields on higher-quality asset lower (and prices higher). Investors may want to consider purchasing the assets the Fed is supporting, such as mortgages, agencies, and high-quality corporate and municipal bonds. In addition, we believe that FDIC-backed bonds can be an alternative to Treasury securities, until their yields are within 25 bps of each other. Although Treasury Inflation-Protected Securities have become more attractive, we still think it is too early to buy them. We expect inflation to fall for a while longer, which likely will lead to a lower income stream and a reduced principal value. January’s strong municipal bond rally has removed the extreme value from this asset class. We still view municipals as attractive to Treasuries and agencies, but corporate bonds now may be more compelling. Longer-dated and lower-quality securities remain the best value in the municipal bond market. Overall, we recommend portfolios maintain a neutral posture relative to their benchmarks while emphasizing the higher-quality assets the Fed is targeting.

Investment Strategy

We maintained our strategic weighting of 60% stocks/40% bonds for our balanced portfolio. For our current tactical allocation, we held the weightings for international small cap, real estate and commodities at 0%, and we continued to divide the international equity allocation between international EAFE value (8.4%) and international EAFE growth (5.6%). We are holding the total allocations to international (EAFE) equity and emerging markets equity at their prior levels (which are below their new strategic, long-term weightings) until conditions become more favorable for these asset classes. U.S. equity valuations largely discount a worst-case scenario and are hesitant to assign much probability of success to the efforts of the Fed and U.S. Treasury. However, we believe a turnaround is on the horizon and therefore are holding our long-term strategic equity weighting.

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