

Market Monthly

An analysis of the economy and the markets

FEBRUARY 2008

■ *The Economy*

The U.S. economy is either in or near a recession, and despite the prevalence of monetary and fiscal stimuli, 2008 will be a challenging year. The Federal Reserve aggressively moved to lower rates by 125 basis points in January. The Fed now seems to grasp the magnitude of the problems facing the economy, having expressed an open-ended commitment to doing whatever it takes to stabilize the economy. The still-tumbling housing market remains the largest impediment to economic growth. According to the S&P/Case-Shiller Composite, home prices are down 7.7% for the past year and are falling at an accelerating pace. We expect 2008 will be another difficult year for the housing market, but housing should be less of a drag on economic growth by year end. Not all housing-market-related news is disappointing, though. The inventory of unsold homes finally has moderated, and the National Association of Homebuilders (NAHB) index has stabilized over the last few months. Regarding inflation, our outlook remains constructive. In fact, the United States currently is undergoing a “debt deflation.” Financial crises historically have led to lower inflation, and we expect this time to be no different. We disagree with those predicting stagflation (stalled economic growth along with rising inflation). When a crisis slows growth, lower growth leads to lower inflation and lower interest rates. We should not be fooled by elevated oil prices, which are more a factor of the weaker dollar (oil is traded in dollar terms) and emerging market demand than inflation. As such, we believe deflation remains a greater threat than inflation. Jobless claims are approaching a level that threatens the economy and for the first time since 2003, the United States experienced job losses in January. It’s unusual for an economy to lose jobs except in times of recession. This factor should keep the Fed on a rate-cutting agenda.

■ *Equity Markets*

Although U.S. government data points to minimal economic growth, anecdotal data and leading indicators suggest a recession. The credit crisis continues to evolve, with portions of it (such as ARM resets) already addressed by government actions, and other segments (leveraged loans, CDOs, etc.) remaining unresolved. Consumer debt, particularly mortgage debt, remains a concern, as broad swaths of the corporate credit market remain in decline. Nevertheless, the Fed is now actively engaged in resolving this crisis, and we expect the central bank to take additional action, including possible steps to support the struggling monoline insurers. The credit contraction is choking off economic activity, which is creating lower revenues and earnings in U.S. markets. We expect this economic weakness to continue to influence earnings growth in the next 12 to 24 months. Yet, due to the decent health of corporate balance sheets and geographically diverse operations, we do not expect the economic weakness to be protracted. Global, multinational companies will continue to benefit from a lower U.S. dollar, but the economies of Japan and Europe are slowing. We expect Japan and European governments to reduce interest rates to address their own domestic economic weakness. Such actions should help stem the U.S. dollar’s decline. We believe companies with global exposure (including those with presence in the emerging markets) and businesses outside the influence of the subprime and housing markets and consumer-spending behavior have an advantage. With reasonably healthy balance sheets and strong free cash flow, non-financial corporations still have the flexibility to implement shareholder-friendly actions — raising dividends, repurchasing shares, and pending the resolution of the liquidity crunch, make accretive acquisitions. 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**

Global short-term interest rates have started to move in sync lately, as Libor rates have been lowered to follow the federal funds target rate. This action stems from the Federal Reserve's launching of the Term Auction Facility (TAF). The commercial paper market is expanding again, but the asset-backed securities (ABS) market is not. The Treasury market remains priced for a meaningful recession. Although we are not optimistic about the economy's growth prospects, we currently do not believe the economy will slip into a deep or long-lasting recession. Fear continues to drive the aggressive Treasury demand and has pushed U.S. Treasury yields lower than our global counterparts. The weak U.S. dollar and lower absolute yields should limit fundamental demand. Investment-grade corporate bond spreads have reached compelling long-term valuations. Although credit concerns have not disappeared, current credit spread levels (+225 basis points above Treasuries) are difficult to ignore. We suggest moving to a neutral or market weighting in this sector. Breakeven spreads currently stand at 35 basis points (they have averaged 10 basis points during the last decade), which means spreads have to widen an additional 35 basis points during the next year before a corporate bond would underperform a similar-duration Treasury. We think the odds have shifted to the corporate buyer's favor. Municipal bond valuations are extremely attractive, with many munis inside 10 years trading at yields above Treasuries. Remember, these yields are tax-exempt! Investors continue to enjoy the lower volatility and safety of the municipal market in these uncertain times. With a presidential election looming, the increased odds of higher marginal tax rates remain a strong selling point for this sector. We recommend maintaining an overweight to agency and municipal securities and a market weight to mortgage bonds. We suggest remaining underweighted in Treasuries, as current yields already reflect a recessionary federal funds target rate of 2.00%. Although investor emotions ultimately could push Treasury yields even lower, we do not believe there is enough fundamental weakness to justify these rates long term. Regarding duration, we recommend a neutral-to-benchmark strategy. The monoline insurers are under tremendous pressure from losses in the mortgage and CDO market. Ambac, XLCA, and FGIC have lost their AAA status, MBIA is on the chopping block, and ACA is steps away from liquidation. The negative ripple effect to banks, brokers and municipalities potentially is staggering. There likely will be some sort of government/bank-sponsored bailout of at least some of the monoline insurers. This is clearly the biggest hurdle now facing the financial community and the economic outlook, and it further reinforces our practice of purchasing bonds based on the underlying quality rating and not just based on the presence of insurance.

■ **Investment Strategy**

We are maintaining a strategic allocation of 60% stocks/40% bonds. 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 a strategic equity weighting at this point, due to the Fed's delayed response to the financial and economic problems, current economic uncertainty, and relatively high earnings expectations. We continue to focus on higher-quality securities, particularly the stocks of financially strong companies with reasonable earnings-growth prospects. The ongoing liquidity crisis could create a variety of stock-specific investment opportunities for companies enjoying strong cash positions.

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