Investment Intelligence®

BB&T ASSET MANAGEMENT

Market Monthly

An analysis of the economy and the markets

MARCH 2009

The Economy

As the new administration tries to "right" the economy, layoffs still are accelerating, with unemployment hitting 8.1% in February. The Gross Domestic Product (GDP) was revised downward for the fourth quarter from -3.8% to -6.2%, marking a level that has not been as bad since the early 1980s. The stock market is down 20% year-to-date, and credit spreads widened in February. Equally as disappointing, there doesn't appear to be any near-term catalyst to turn things around. The government's updated growth forecasts call for a contraction of 0.5% to 1.3% for 2009, and growth of 2.5% to 3.3% for 2010. We believe both forecasts are overly optimistic. Regarding inflation, the Fed's target for the core Personal Consumption Expenditures (PCE) index is 1.7% to 2.0% for the next six years. Currently, the core PCE is only 1.6% and is falling. Despite the government's "whatever it takes" attitude toward calming the financial markets, some of its actions actually have been the equivalent of throwing gasoline on a fire. For example, President Obama's proposal to raise taxes as early as this fall won a sharply negative reaction from the financial markets. The markets were alarmed by the president's desire to increase the tax burden of Americans in the midst of the worst economy in decades, without regard for the further dampening effects such tax hikes surely would have on the economy. Corporate earnings continue to be revised downward, and many financial companies are cutting their dividends to preserve cash. The bailout requests keep coming in, and talk of nationalizing Citigroup, Bank of America, AIG and/or the automakers persists. Furthermore, the government announced it will "stress test" the 19 largest financial firms during the next few weeks. This constant overhang of potentially bad news continues to weigh on investors, dragging down sentiment and deterring private investment. From an international perspective, there remains a disparity between the European Central Bank (ECB) and the Federal Reserve. The ECB, which has been slow to cut interest rates, is clearly behind the curve. As U.S. money supply is growing close to 16%, money supply in the Eurozone has been contracting. It appears the ECB has not acted quickly or aggressively enough, which may lead to a more painful economic outcome for Europe. Another issue is the euro, and how it fares during the downturn. Some observers have started to question the long-term viability of the currency.

Equity Markets

Recent corporate financial reports confirm that the severe global recession continues. 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. Although the Obama administration has taken many steps to support the financial markets, it is doing too little to reset mortgage liabilities. The $75 billion plan to help homeowners avoid foreclosure is a positive measure, but it fails to address the magnitude of the problem. The economy needs additional efforts to stem foreclosures and stabilize home prices. We are seeing some increased demand for homes and subsequent improvements in home inventory levels, but a possible recovery in housing is tenuous, considering rising unemployment easily could exacerbate the problem. Home prices currently are on track to stabilize within the next 12 months or so. Stabilization is an important milestone. Once home prices stabilize, the markets will be able to price many toxic assets at some salvage value, which in turn will strengthen liquidity in the banking system. We continue to believe the path to stabilization is fragile, and we look to the Obama administration to provide leadership in addressing the credit crisis. European economies have deteriorated sharply. The credit crisis is intensifying in Europe, which has led to relative strength for the U.S. dollar. Nevertheless, at some point international economies 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. We remain concerned that the horrific economic declines in several export-driven countries will lead to unwelcomed strength in the U.S. dollar. 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 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 weightings across all portfolios.

Fixed Income

The Treasury yield curve continued to steepen in February, as two-year Treasury yields increased by only 2 basis points (bps) while 10- and 30-year Treasury yields increased 17 bps and 11 bps, respectively. Investor uncertainty and massive Treasury issuance are weighing on the market, and we do not believe higher yields are sustainable in this deflationary environment. We are concerned about spreads, which in February widened 25 bps in the investment-grade corporate bond sector and 70 bps in the high-yield segment. The Chicago Board Options Exchange Volatility Index (VIX), a widely used measure of market risk, has moved back up to the upper 40s and low 50s. (So far, the range for 2009 has been 39 to 57; a higher number indicates greater volatility.) Historically, higher volatility has been correlated with wider spreads, so the recent uptrend is troubling. Negative corporate earnings announcements, combined with scrutiny of the financial institutions, appear to be hurting the corporate bond sector. High-quality companies have been able to borrow, but the credit markets, which had been functioning better, are starting to deteriorate again. Nevertheless, corporate borrowing costs are on the Fed's radar screen, and if the market does not heal this sector on its own, we expect the Fed would purchase investment-grade corporate bonds to reduce corporate America's borrowing costs. The Fed remains committed to driving yields on higher-quality assets lower (which would push prices higher). Therefore, investors may want to consider purchasing the assets receiving Fed support, including mortgages, agencies and high-quality corporate and municipal securities. 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 (TIPS) have become more attractive, we still think it is too early to purchase them. We expect near-term inflation to continue to decline, which likely will lead to a lower income stream and reduced principal value among TIPS. The recent strong rally in the municipal bond sector has removed the extreme value from this asset class. We still view municipals as attractive compared to Treasuries and agencies, but we believe corporate bonds now may be more compelling. Longer-dated and lower-quality municipal bonds currently offer the best value. We may see renewed interest in municipal bonds in the coming months, particularly if President Obama's proposal for a higher top marginal tax bracket of 39.6% becomes a reality. Overall, we believe fixed-income portfolios should remain neutral to their benchmarks, emphasizing the higher-quality assets the Fed is supporting. We would consider any meaningful backup in yields as a buying opportunity.

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 long-term strategic 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. We believe a turnaround is on the horizon and therefore are holding our long-term strategic equity weighting.

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