BB&T ASSET MANAGEMENT

Investment Intelligence®

Market Monthly

An analysis of the economy and the markets

MARCH 21, 2006

The Economy

Economic forecasters are now expecting much of 2006's economic growth to be front-loaded. Although the overall average annual growth-rate forecast of approximately 3.4% remains intact, the quarterly estimates have changed. In particular, unseasonably warm weather has played a dominant role in the strong first-quarter growth forecasts of 5% or more. We expect second-quarter economic growth to slow meaningfully, as weather-related influences subside. Furthermore, consumers have spent more than they have earned during the past two years, and our expectations for future conditions are not optimistic. Although we expect consumer spending to remain positive, we also believe it will slow down. Our outlook for business and government spending remains positive, but we don't expect either sector to be strong enough to prevent a slowdown in GDP growth. In his debut as Federal Reserve chairman, Ben Bernanke reaffirmed the general belief that future Fed decisions would be data dependent. We believe the Fed already is in the overshoot phase, and given the lag effect of the Fed's rate increases and the projected slowdown in economic growth, we believe further rate increases are unnecessary and likely will need to be removed by year end. Nevertheless, we expect the Fed to raise rates again this month. But by stating "some further policy firming may be needed," future moves remain unclear. We still believe the economy will achieve a soft landing, but further rate increases could challenge that assumption. In addition, the Fed remains concerned about the unemployment rate as a possible source of inflation.

Equity Markets

Steady economic growth, relatively contained inflation, low long-term interest rates, and reasonable valuations among large-capitalization stocks continue to provide a favorable backdrop for the equity markets. Yet, the markets won't realize the full force of these positive factors until the Fed puts an end to its current rate-hike campaign. Corporate performance remains encouraging, as healthy balance sheets and strong free-cash flow are contributing to such shareholder-friendly actions as dividend increases, share repurchases, and corporate acquisitions. In addition, earnings growth continues, albeit at a decelerating pace, and corporate profit margins remain at record levels in the face of growing pressures from rising short-term interest rates and higher commodity prices. 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, a slowing economy and a likely near-term conclusion to Fed tightening eventually should put downward pressure on the U.S. dollar. This may improve the stock performance among large, multinational corporations. With lower-than-normal premiums, we believe high-quality, large-cap growth stocks remain attractively valued. Despite the positive influences, we still have some concerns for the equity markets, including the headwinds facing the U.S. consumer. Rising short-term interest rates, higher energy prices, declining housing affordability and a peaking housing market are expected to take a toll on consumer spending. In addition, Federal Reserve tightening cycles generally lead to some type of financial crisis, and we have yet to experience such a setback.

Bond Markets

We believe long-term interest rates have peaked for this cycle, and we recommend investors maintain longer-than-benchmark durations in their fixed income portfolios. Despite recent rate increases in the 10-year-and-shorter portion of the yield curve, we believe the Federal Reserve has succeeded in taming inflation, and interest rates are poised to fall throughout the next six to 12 months as the economy begins to cool off. The Treasury yield curve remains inverted, which confirms our belief in low inflation and slowing growth. We continue to advocate a "laddered" portfolio structure, emphasizing bonds in the four- to 10-year part of the yield curve. In addition, we expect bonds with good call protection to perform better in a falling or bullish rate environment. Mortgage securities remain our favorites, particularly current coupon and slight discount bonds, which should perform better in a falling interest rate environment. We continue to underweight corporate bonds based on their expensive valuations and managements' focus on stockholder-friendly activities. We also recommend at least a market weight in government bonds to guard against a financial crisis and to benefit from the expected slowing economy. Despite their recent outperformance and negative seasonal trends, municipal bonds remain attractive due to a sharp reduction in supply. The U.S. Treasury market continues to enjoy a strong yield advantage relative to most foreign government markets. But as the world becomes more globally integrated, so will the financial markets, and we therefore anticipate a convergence of bond yields. Yet, continued unrest in the Middle East should offer support for the U.S. bond market as a safe haven.

Investment Strategy

We continue to overweight equities, with a recommended tactical asset allocation of 65% stocks/ 35% bonds, unchanged from last month. This allocation reflects our belief that stocks will outperform bonds throughout 2006. Steady economic growth, relatively contained inflation, low long-term interest rates, and reasonable stock valuations provide a favorable backdrop for equities. Nevertheless, consensus expectations for future earnings growth have moved higher, making the market more vulnerable to disappointments. We are maintaining a quality bias, buying the stocks of financially strong companies with reasonable earnings growth prospects. Within our large-cap equity allocation, we are converting our value approach to a core strategy, focusing on value and growth stocks in a process we believe will better serve our clients. In evaluating prospective investments with this investment approach, we may consider factors such as the market price of a company's securities relative to the company's long-term earnings, asset value and cash flow potential, as well as historical value measures such as price-to-earnings ratios, profit margins and liquidation values.

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