

# Market Monthly

*An analysis of the economy and the markets*

APRIL 2007

## ■ *The Economy*

The U.S. economy has been growing at a below trend pace for the last three quarters. We believe housing has not yet bottomed and should remain a drag on economic growth into 2008. Housing prices have fallen 0.2%, year over year, mortgage equity withdrawal is slowing dramatically, and delinquency rates are up. We have yet to see the full impact of tighter lending standards. Real estate downturns always have been accompanied by a significant slowdown in consumer spending, and this downturn should not be any different. The Federal Reserve has predicted the bottom in housing twice already and now admits “the adjustment in the housing sector is ongoing.” Typically, the economic chain of events unfolds with corporate profits falling, companies cutting their capital expenditures, employment dropping and, finally, consumer spending stalling. So far, we’ve seen profits fall and corporate spending decline. History suggests employment will be next. The Fed continues to closely monitor the inflation rate, which, at 2.4% (Core Personal Consumption Expenditures, PCE, Index), is 30 basis points above the high end of the Fed’s target range. The Fed continues to believe the risk of higher inflation outweighs the risk of slower economic growth. We disagree. We believe the U.S. economy is more likely to experience a growth recession than runaway inflation. If we remove the impact of rent costs, the current PCE is approximately 2.0%. Furthermore, we believe there’s a good chance the owner’s equivalent rent (OER) will pull core PCE down to 1.5% by year end. Just as OER caused inflation to spike higher in 2006, the reverse should happen in 2007. Currently, the Fed’s forecast calls for real GDP of 2.5% to 3.0% this year, PCE of 2.0% to 2.25% and unemployment of 4.5% to 4.75%. We are not as optimistic for the economy, though, with a GDP forecast of 2.0% to 2.5% for the year, a PCE forecast of 1.7% to 2.0%, and unemployment forecast of 4.75% to 5.0%.

## ■ *Equity Markets*

Slowing economic growth, contained inflation, moderate long-term interest rates and reasonable valuation levels continued to provide a favorable backdrop for equities. We believe the recent sub-prime lending meltdown should stay contained within the lower end of the mortgage market. Although we have yet to see — and do not expect — a broad-based tightening of lending standards, we will watch this issue closely. A general tightening of credit could help throw the economy into recession. We believe the equity market has additional upside potential. Earnings growth, although moderating, remains healthy, and price-to-earnings multiples are below long-term averages, indicating stocks remain attractively valued. Lower interest rates combined with the prospect of the Federal Reserve easing later in the year should lead to multiple expansion, which would offset the impact of slower earnings growth. With healthy balance sheets and strong free-cash-flow, corporations have the flexibility to take shareholder-friendly actions (raise dividends, repurchase shares, make accretive acquisitions). Heightened mergers-and-acquisitions activity and private equity deals tend to validate our assessment that stocks generally are cheap. The U.S. trade deficit and slowing economic growth combined with the shrinking short-term interest rate differential for the U.S. relative to the rest of the developed world should continue to put downward pressure on the dollar. Assuming the dollar’s weakening is orderly, multi-national companies should benefit from this trend. An increasingly populist tone has been emerging from Congress. Recent trade disputes with China may reflect a growing protectionist view in Washington, D.C. Enacted tariffs resulting from this view are potentially inflationary for the U.S. economy, and we will closely monitor trade policy and Congressional action. Business and consumer spending have softened in recent months. The U.S. consumer, the cornerstone of the global

expansion, continues to face significant headwinds from higher energy prices, low housing affordability and a weak housing market. Because of these and other factors, we expect global growth to exceed growth in the United States.

### ■ **Fixed Income**

At the March meeting of the Federal Open Market Committee, the Fed finally lifted its tightening bias by removing from its monetary policy statement the language alluding to “additional firming.” This should pave the way for an actual “balanced risk” assessment and, ultimately, an ease in policy later this year. We continue to believe most inflation measures will move below 2%, year over year, in 2007, giving the Fed confidence to take its foot off the brake. We still expect short-term securities (two- to five-year maturities) to benefit most from an eventual Fed ease. Two- to five-year rates have fallen 20-25 basis points year to date, while 30-year rates remain unchanged. The Fed has a direct impact on rates inside of five years, and as interest rate policy eases, the yield curve should steepen. Nevertheless, the Fed has yet to signal any near-term movement out of the neutral camp. Investors should be prepared for the market to remain in a relatively flat yield curve environment for a prolonged period of time. Currently, bond yields appear fairly priced, but we expect them to move lower as inflation data soften. Although economic growth has slowed, inflation has remained stubbornly above the Fed’s comfort zone. Currently, breakeven inflation rates on 10-year TIPS (Treasury Inflation-Protected Securities) are 2.45%. We believe this is too high and would avoid TIPS right now. We maintain our preference for interest rate risk (mortgages and callable agencies) over credit risk (corporate bonds), and we suggest investors structure their portfolios with a built-in income advantage by overweighting mortgages and callable agencies. Corporate spreads remain historically tight, and we believe they do not adequately compensate investors for the decline in credit fundamentals and the ever-increasing levels of event risk. Deteriorating credit conditions and tighter bank-lending standards generally are a precursor to wider corporate spreads. Volatility has increased, and corporate spreads have widened modestly in the last month, with more widening likely to come. Overall, we would like to see a meaningful adjustment to inflation and employment before we become more bullish on the bond market. Nevertheless, we would view any significant sell off as an attractive buying opportunity.

### ■ **Investment Strategy**

We continue to recommend a tactical asset allocation of 65% stocks/35% bonds. This allocation reflects our belief that longer-term market conditions should favor stocks over bonds. Slower economic growth, a reduction in inflationary pressures, relatively low long-term interest rates, and reasonable stock valuations provide a favorable backdrop for equities. Within the stock market, we continue to favor higher-quality securities, particularly the stocks of financially strong companies with reasonable earnings growth prospects. We continue to reduce our former large-cap overweight. Specifically, throughout the next two months we will decrease our allocation to large-cap stocks and increase our allocation to mid-cap stocks. This action will move our target portfolio back toward the long-term strategic weightings to large- and mid-cap stocks.

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