

# Market Monthly

*An analysis of the economy and the markets*

MAY 2009

## ■ *The Economy*

Recently, many leading economic indicators have improved, suggesting the economy may be on the mend. For example, the stock market appears to have bottomed, credit spreads are narrowing dramatically, the yield curve is steep, and first-quarter earnings are beating estimates. Although corporate earnings overall continue to decline, some surprises (less negative than expected) in the banking industry have provided a glimmer of hope. Furthermore, more than half of the 19 largest banks subjected to government “stress tests” have raised private capital in the last month, the first step toward repaying their TARP (Troubled Asset Relief Program) bailout funds. The government remains committed to keeping interest rates low for the foreseeable future. The Treasury Department has been able to drive down mortgage rates to the 4.5% range by purchasing Treasury and mortgage-backed bonds in the secondary markets. This, in addition to affordable gas prices, large tax refunds and lower payroll taxes, has helped boost consumer spending, which was positive in the first quarter. Nevertheless, housing remains a challenge. We do not expect the housing market to turn around until the unemployment rate improves, and that seems unlikely until the end of the year. Still, these factors — housing and employment — are lagging indicators. The financial markets are forward-looking and already have discounted additional negative news on housing and unemployment. Political risk, dormant for many years, is now a mounting force, demonstrated most recently by the fallout from the Chrysler bankruptcy and the Obama administration’s proposed treatment of the company’s debt holders. President Obama wants the bondholders (higher on the capital structure) to take a reduced position in favor of the United Auto Workers union and the employees. This merits attention, because it essentially would change the rules in the middle of the game by altering the capital structure and bankruptcy laws under which the debt holders initially invested in the company. Looking ahead, the worst of the recession, as measured by GDP, likely is behind us. The typical business cycle pattern of a sharp drop in demand followed by an inventory correction should lead to an increase in demand and a recovery, albeit at a slow pace. Long-term growth likely will be below historical averages, due to the headwinds of deleveraging, higher taxes, increased regulation, and the housing overhang.

## ■ *Equity Markets*

Recent stock market gains suggest investors are responding to the dramatic improvements in the credit markets. We believe the current rally should no longer be considered a bear market rally, but a partial recovery. It appears the “reflation” efforts of the Federal Reserve (the Fed) and U.S. Treasury are beginning to work. Corporate earnings reports are exceeding analyst estimates, credit spreads are narrowing dramatically, the rate of deceleration in the economy is slowing markedly, commodity prices are increasing, and bond and stock investors are shrugging off bad news. We remain optimistic and are maintaining our long-term strategic equity weightings across all portfolios. The government’s steps to reduce mortgage rates have set in motion some potential housing market stabilization, even as foreclosures continue. An increase in refinancing activity is either lowering monthly expenses or reducing economic uncertainty for homeowners. Furthermore, demand for homes is improving. The government’s reflationary efforts will have the greatest impact in the financial sector, where those companies that were most at risk, including those with the weakest capital positions and worst credit profiles, stand to gain the most from this nascent recovery. High-quality financial names likely will lag. As credit spreads and bond prices improve, capital levels and risk profiles will improve considerably. This phenomenon will help banks and insurance companies repair their balance sheets, and their stocks should perform well. Looking ahead, once foreign economies begin to stabilize, their currencies should perform better than the U.S. dollar, as the flight to the safety of the dollar unwinds, and the U.S. budget deficit grows. Although a weaker dollar generally is a positive factor for Americans invested overseas, the impact may be offset by President Obama’s decision to tax multinational companies at the same tax rate abroad as in the United States. This action will impair the ability of U.S. multinational companies to compete abroad, and the stocks of these companies may struggle.

## ■ **Fixed Income**

Treasury yields rose in April, as investors grew less fearful and less risk-averse. Market indicators and corporate earnings also helped buoy hopes that although economic activity was likely to remain weak, it was still improving. Corporate borrowing costs also responded to investor optimism. Investment-grade spreads plunged more than 100 basis points (bps) within the last month, while high-yield spreads narrowed by 300 bps. Compared with their peaks reached late last year, investment-grade and high-yield spreads have narrowed by 200 bps and 800 bps, respectively. Volatility, as measured by the Chicago Board Options Exchange VIX index, has fallen from a high earlier this year of 56 to its current level of 35. (Volatility and corporate spreads are highly correlated, and a higher index reading indicates stronger volatility.) Positive corporate earnings announcements have contributed to this tempered volatility. We suggest investors overweight corporate bonds at the expense of Treasury and mortgage-backed holdings. The Fed remains committed to driving yields lower on higher-quality assets. Therefore, investors should focus on the assets the Fed is supporting, including agencies, high-quality corporate bonds, and municipal bonds. We continue to recommend buying FDIC-backed bonds as Treasury alternatives until their yields are within 25 bps of each other. Although TIPS (Treasury inflation-protected securities) have received a lot of attention as a hedge against future inflation, we still think it is too early to buy them. We expect inflation to decline for a while longer, but a better TIPS buying opportunity should emerge later. Municipal bonds remain attractive, but they no longer yield more than Treasury notes. The best values in the municipal market are in the 10- to 20-year range and in essential service (water, sewer, hospital, etc.) revenue bonds with “A” and “BBB” quality ratings. While absolute yields are low for bonds with “AAA” quality ratings, quality spreads remain compelling. We expect to see increased interest in municipal bonds, due to higher federal and state tax rates. The BAB (Build America Bond) program, which lets municipalities issue taxable debt and receive a 35% interest credit from the government, has been well received. This program should help keep municipal yields low and prices well supported. Overall, we recommend investors remain neutral to or slightly shorter than their benchmarks and emphasize corporate bonds, agencies, and municipal bonds. We believe it is now appropriate for those clients who have a greater tolerance for risk to consider high-yield bonds. We also believe longer-duration assets should consist of non-Treasury securities.

## ■ **Investment Strategy**

We maintained our strategic weighting of 60% stocks for our balanced portfolio, but we slightly reduced our fixed-income exposure to 38.5% and initiated a 1.5% position in commodities. Economic growth in China, a major driver of demand for commodities, is beginning to reaccelerate. The supply-side reduction in many commodities has been significant and has begun to support prices. Stabilization in global demand eventually should trigger inventory rebuilding. For our current tactical allocation, we had no exposure in international small cap or real estate, and we continued to divide the international equity allocation between international EAFE value (8.3%) and international EAFE growth (5.5%). We increased our allocation to emerging markets equity, from 6.25% of the total equity allocation to 8% of the total equity allocation. Global risk aversion is waning, which is a positive factor for emerging markets stocks. Emerging economies generally have weathered the recession better than developed countries and are likely to have stronger recoveries.

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