

Market Monthly

An analysis of the economy and the markets

AUGUST 8, 2006

■ *The Economy*

After implementing 17-consecutive interest rate hikes, which pushed the federal funds rate from 1.00% in June 2004 to 5.25% at the Federal Open Market Committee (FOMC) meeting on June 29, 2006, the Fed took a pause at today's FOMC meeting, leaving interest rates unchanged. Driving the Fed's decision was a desire to weigh the slowing economic data against continued elevated inflation. In particular, GDP growth declined to 2.5% during the second quarter, from a robust pace of 5.6% in the first quarter. The Fed attributed the slowdown in growth to a cooling housing market, the lag effect of rising interest rates, and higher energy prices. Labor costs showed modest increases during the second quarter, and for the first time in several meetings, the Fed made no mention of productivity gains holding down labor costs. Despite these and other pressures on inflation, and some expectations for a near-term increase in the inflation rate, the longer-term outlook is for core inflation to remain well-contained. The Fed stated, "inflation pressures seem likely to moderate over time, reflecting contained inflation expectations, the cumulative effects of monetary policy actions and other factors restraining aggregate demand." As we have pointed out throughout the last several months, this scenario seems likely, considering inflation is a lagging indicator that generally takes at least six months longer than the overall economy to be influenced by Fed policy. Unrest in the Middle East may continue to put pressure on energy prices, resulting in higher overall inflation. However, this type of inflation tends to act as a tax on the economy, as elevated energy costs, coupled with higher interest rates, cut into consumers' disposable income. Currently, priced into the futures market is a 30% to 40% chance of another Fed rate increase. We believe another rate hike is unlikely, due to the ongoing slowdown effects of the higher interest-rate environment.

■ *Equity Markets*

The stock market initially responded favorably to the Federal Reserve's decision to keep interest rates steady. But, as investors digested the Fed's statement, which left the door open for additional rate hikes down the road, enthusiasm waned. Nevertheless, from a big-picture perspective, the pause in the tightening cycle, combined with slowing economic growth, contained longer-term inflation prospects, relatively low long-term interest rates and attractive large-cap stock valuations (the S&P forward price/earnings ratio is at a 20% discount to its 10-year average) are contributing to a favorable backdrop for stocks. Furthermore, capital spending remains strong, and still-healthy balance sheets and strong free cash flow continue to give corporations the ability to maintain shareholder-friendly actions, including raising dividends, repurchasing shares and making strategic acquisitions. In addition, the large 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, should continue to put downward pressure on the dollar. This pressure should benefit large, multi-national companies on a relative basis, assuming the dollar's weakening is orderly. Despite the favorable, "big-picture" influences on the market, there are some concerns. For example, it may take the prospect of a Fed easing campaign for the stock market to experience multiple expansion. In addition, while earnings growth remains healthy, the pace of that growth continues to moderate. Also, consumer spending, which accounts for approximately two-thirds of GDP, continues to face growing pressures from higher interest rates and energy prices combined with rising mortgage and home equity loan rates. A healthy pace of business spending should offset some, but not all, of the slowdown in consumer spending. Finally, the economy still has yet to experience any financial crisis from the lengthy Fed tightening campaign. The recent pause in the tightening campaign does not eliminate this potential threat.

■ **Fixed Income**

Expectations for a slowdown in economic growth pushed yields down across most of the yield curve. At the same time, the yield curve regained its positive slope, slowly but surely. For example, the yield difference between the three- and 30-year bonds increased from three basis points to 17 basis points during the month. We expect the curve to steepen further as the market anticipates economic growth to show additional signs of slowing. Shorter-term rates (less than three years) may stay elevated until the market foresees a Fed rate cut. Given the expectations for slower economic growth, the market's tolerance for a higher level of near-term inflation is a bit greater. As growth continues to slow, it seems likely inflation eventually will moderate. It's important to note that after each of the last three Fed tightening cycles, the 10-year Treasury yield fell more than 100 basis points (from the time of the last Fed hike to the first Fed rate cut). We recommend investors maintain longer-than-benchmark durations for intermediate and longer-term portfolios and slightly-greater-than benchmark durations for short-term portfolios. If the Fed has any more bullets left to fire, we believe it only will aid the cause for bond investors by making yields more attractively valued. We recommend a "laddered" maturity structure by emphasizing bonds in the four- to 10-year maturity range to take advantage of the likely steepening of the yield curve throughout the next six to 12 months. We also recommend a continued emphasis on high-quality securities, including mortgage-backed bonds, agencies and municipal securities. Investors have been sellers of risk throughout the last few months, demonstrated by the sharp correction in commodities and emerging markets and by the widening of credit spreads. We believe the credit cycle has peaked, as corporations likely will continue to distribute excess cash to stock holders in the form of increased share buybacks and dividends. In addition, ongoing mergers and acquisitions activity and increased capital spending continue to highlight managements' preference for enhancing shareholder value at the expense of bondholders.

■ **Investment Strategy**

Although the stock and bond markets continue to struggle with volatility, we are maintaining a recommended 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 contained inflation outlook, relatively low long-term interest rates, and reasonable stock valuations provide a favorable backdrop for equities. Within the stock market, we are maintaining a quality bias, purchasing the stocks of financially strong companies with reasonable earnings growth prospects. In particular, we are overweighting large-cap stocks, due to their attractive valuations and the desire to maintain a more-defensive equity exposure.

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