Investment Intelligence®

Market Monthly

An analysis of the economy and the markets

BB&T ASSET MANAGEMENT

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The Economy

We expect a GDP growth rate of approximately 2.0% for the remainder of the year, with an asymmetric risk to the downside. In his testimony before Congress, Federal Reserve Chairman Ben Bernanke stated he expects the economy to grow at a moderate pace this year and a bit stronger in 2008, despite the Fed lowering its GDP forecast for 2007 to 2.25%-2.5%, from 2.5%-3.0%, and 2008 GDP to 2.5%-2.75%, from 2.75%-3.00%. We do not share the Fed's optimism and believe the housing/subprime-induced credit crunch will have a greater near-term impact on slowing growth. For example, rapidly rising defaults and losses among subprime loans recently helped spread market panic to other credit sectors such that even creditworthy borrowers had trouble accessing credit. The Federal Reserve and other central banks injected liquidity into the system to help unlock seized up capital markets for the first time since September 11, 2001, suggesting the Fed may be closer to easing if market jitters don't calm down. Housing measures continue to erode, with existing home sales reaching a new cycle-low and the supply of homes remaining at a highpoint for the current cycle. New single-family home sales plunged 6.6% during June, and home prices are down 2.8% during the past year, according to the S&P/Case-Shiller Home Price Index. We believe the continued decline in the housing market and related impact on consumers may significantly impede U.S. economic growth. Nevertheless, inflation remains the predominant concern for the Fed—a position we believe is misguided. Given the housing and credit challenges in the market, the Fed should have equal concerns for growth prospects. Inflation, as measured by Core PCE (Personal Consumption Expenditures Index) has fallen to 1.9% and is trending lower, which is within the Fed's stated tolerance range. But the lofty price of oil has reignited concerns about broader inflation measures. Employment remains a bright spot, as weekly initial jobless claims remain relatively low. In addition, the market for highly skilled workers remains tight, placing upward pressure on wages. Although job losses appear to be low, job creation does not appear to be booming either. Non-farm payrolls for July came in at a disappointing 92,000, below the forecasted 127,000, and the unemployment rate moved up a notch to 4.6%. We believe the employment situation has been instrumental in maintaining consumer and economic strength. Softer employment may entice the Fed to ease on concerns of reduced production from dwindling consumer sentiment. Yet, despite the anticipated consumer slowdown, we still believe the United States will avoid a recession, thanks to global growth and decent corporate health.

Equity Markets

We believe equities in general remain more attractive than bonds, and the current liquidity crisis may create a variety of stock-specific investment opportunities for those companies with strong liquidity. The collapse of portions of the credit markets may threaten economic growth. However, in previous credit cycles, liquidity evaporated during a period of one to three months and then resumed thereafter. We expect a similar pattern from the current credit crunch, with the credit markets stabilizing within approximately three months. The Fed has clearly demonstrated its willingness to resolve this problem and stabilize the credit markets. As long as this stabilization occurs, we expect modest, but positive, economic growth in the second half of 2007. Also, despite a recent slowdown in domestic business spending, international growth remains strong, which is providing a lift to U.S. exports. Furthermore, earnings growth should continue to be driven by strength in the industrial economy, commodities and services. Nevertheless, this growth may be partially offset by sluggish retail sales throughout the next several quarters. U.S. corporations continue to exhibit reasonably healthy balance sheets and strong free-cash flow. These factors continue to provide companies the flexibility to take shareholder-friendly actions, including raising dividends, repurchasing shares and making accretive acquisitions. The U.S. dollar continues to face pressure from the U.S. trade deficit, the slow-growth economy and the shrinking short-term interest-rate differential for the United States versus the rest of the developed world. Assuming the weakening of the dollar remains orderly, global multinational companies should benefit from the falling dollar combined with the overall strength of the global economy. On a cautionary note,

Congress continues to promote an increasingly populist tone. Recent trade disputes with China may reflect a growing protectionist view in Washington, D.C. Any tariffs resulting from this view may trigger higher domestic inflation, so we will closely monitor trade policy and Congressional action.

Fixed Income

The bond market is experiencing a flight to quality, with Treasuries leading the way. Spread product has not faired well in this environment. Although interest rates rose during the second quarter due to moderate economic growth and the Fed's inactivity, rates have since moved lower due to the recent credit crunch led by the subprime mortgage market. In addition, the yield curve's shape is significantly steeper. The credit crunch appears to be spreading to higher-quality borrowers, as indicated by the 75-basis-point increase in jumbo mortgage rates (on loans greater than $417,000) during the last few months. Indeed, the greatest spread widening has occurred in the lower-credit-quality sectors, but investment-grade corporate bonds, agencies and mortgage-backed securities (MBS) have not gone unscathed. Investment-grade corporate option-adjusted spreads (OAS) have widened approximately 45 basis points in the last month. Although we remain reluctant to purchase corporate credits at this point, we believe current market action is creating a buying opportunity in the agency and agency MBS markets. Municipal bonds remain attractive, based on good relative value to Treasuries, a bias toward higher tax brackets from the Democrat-controlled Congress, aging baby boomers, improving credit-rating migration and lower volatility. We believe investors in the 25% or higher tax bracket should strongly consider this asset class. The 10-year Treasury yield has moved back closer to fair value, and we suggest maintaining portfolio durations at or slightly longer than benchmark durations for now. We continue to advocate a bullet-type portfolio structure, with emphasis around the five-year portion of the yield curve. In addition, the yield on the 10-year Treasury has closed the gap with our European counterparts. The market is now expecting a Fed ease prior to year end. We agree with this assessment, if the credit crunch (lack of liquidity in the bond market) proves to be long term. Nevertheless, if the credit crunch remains temporary, the Fed's current forecast will prove to be accurate, and the recent Treasury rally will prove to be overdone.

Investment Strategy

We continue to recommend a tactical asset allocation of 65% stocks/35% bonds for our balanced portfolio. This allocation reflects our belief that longer-term market conditions should favor stocks over bonds. With price-to-earnings multiples below long-term averages, stocks remain attractively valued. We continue to favor higher-quality securities, particularly the stocks of financially strong companies with reasonable earnings-growth prospects.

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