Investment Intelligence®

Market Monthly

An analysis of the economy and the markets

BB&T ASSET MANAGEMENT

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The Economy

October was a particularly painful month for investors and a busy one for regulators. The U.S. Federal Reserve, the European Central Bank and the Bank of England initiated a coordinated global central bank "easing campaign" targeting the global financial market crisis and economic tailspin. In addition, other countries, including Germany and China, launched their own stimulus packages. The U.S. government began implementing the Troubled Asset Relief Program (TARP), and the Fed made passive equity investments in the largest U.S. banks. Recently, the Fed has been contemplating aid for struggling U.S. auto companies, insurance companies, and other finance-related companies including General Electric and CIT Group. The Fed also has been buying commercial paper and mortgage-backed securities, which is helping to thaw the frozen credit markets. Investors are shifting their attention to market fundamentals and economic data, which point to rising unemployment, slowing manufacturing, sagging consumer spending, weak stock prices, high credit spreads, tight lending standards and overall low confidence levels. Third-quarter GDP slipped to -0.3%, likely marking the official start of the recession most Americans have been feeling for months. Congress is likely to deliver another stimulus package in the face of this weak economic data. On a positive note, the financial crisis and deleveraging process are deflationary, as indicated by falling commodity prices (oil, steel, wheat, corn). Furthermore, the ongoing housing market meltdown also will help drive down inflation throughout the next several months. President-elect Barack Obama's victory and the massive Congressional swing toward the Democratic Party will have implications for the financial markets. In particular, the country will face more regulation, more union labor concessions and higher taxes on individuals, dividends and capital gains. Some regulation of the subprime and derivatives markets will be healthy, because of the greater transparency it should ignite. Higher labor costs and taxes and more regulation most likely will present a headwind for an already weak economy. President-elect Obama's appointment of a new Treasury secretary and how the TARP is dealt with are crucial decisions we are monitoring.

Equity Markets

Corporate financial reports are now confirming a sharp global recession. We remain concerned about companies with high fixed costs and operating leverage. As revenues head south, such positions can create large cash losses. The government's action to extend protection to commercial paper markets tempers our concerns somewhat about companies' ability to secure financing in this environment. Companies that have stable demand for their products and are internally financed should weather the storm reasonably well. As stock prices correct, we also expect the market will offer some truly outstanding long-term opportunities, the benefits of which won't be realized until the financial crisis is resolved. The good news is the Federal Reserve and U.S. Treasury have adopted a "do whatever it takes" approach to the crisis, as indicated by the passage of the TARP, support of the commercial paper market, and coordinated global rate cuts. The situation is complex and dynamic, but we are encouraged by the U.S. government's actions and believe the market perhaps is ignoring its eventual likely success. Equity valuations largely discount a worst-case scenario and appear to assign a low probability of success to the Fed and U.S. Treasury's all-out efforts. The Fed has become much more aggressive lately and continues to pursue a broad-based strategy, rather than the ad hoc approach with which it started early in the crisis. Nevertheless, the Fed's actions have yet to overcome the crisis, and as long as credit is tight and the global economy deteriorates, investors will remain risk-averse, waiting for the deleveraging process to unfold. The uncertainties created by this phase of the crisis have weakened the housing market further. This factor — combined with weak economic growth, falling employment, the need to rebuild savings, and wider credit spreads — likely will lead to further deterioration in consumer spending. Outside the United States, the intensifying credit crisis is causing European economies to tumble. These countries likely will have a more difficult time managing the crisis, due to the challenges involved in creating a coordinated continent-wide solution. Therefore, foreign currencies have little upside potential versus the U.S. dollar and likely will weaken further.

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Fixed Income

The Federal Reserve cut its federal funds rate target by 50 basis points to 1% in October. In the coming months the Fed may have to push the rate even lower, perhaps to 0%. The European Central Bank also cut rates by 50 basis points, to 3.25%, while the Bank of England slashed rates by 150 basis points to 3%. The commercial paper market is starting to function again, due to Libor (London interbank offered rate) falling and massive amounts of money being injected into the financial system. These represent steps that must occur before the financial markets experience broad improvements. Treasuries remain the best-performing fixed-income asset class so far this year, as the soft economic outlook, poor housing market, weakening credit picture and widespread market fears have sent investors fleeing to the safety of the highest-quality investments. The government's support of Fannie Mae and Freddie Mac and the launch of the TARP have led to tremendous new issuance of Treasury securities, as the nation's debt burden has grown. But the general economic weakness should keep yields from increasing very much. Spreads on investment-grade corporate bonds topped 575 basis points, while high yield spreads surged to more than 1,500 basis points. This is a clear sign the bond market does not expect good economic news in the near future. It may be too early to call a peak in spreads, but we have seen some stabilization in the last few weeks. We will continue to monitor spreads in hopes of confirming a turning point. We will consider adding short-term credit where breakeven spreads are wide and some higher-quality names that are better insulated from a weak economy. After weathering the massive selling from hedge funds and mutual funds earlier in the year, the municipal bond market has performed well in recent weeks. Given the market's expectations for low inflation, the relationship between comparable-duration municipals and Treasuries remains attractive (110% or higher in the intermediate range), while absolute yields of approximately 4% in the 10-year range indicate good value. Barack Obama's presidential victory combined with a Democrat-controlled Congress suggests marginal tax rates will be higher in the future, possibly as soon as next year. This factor, along with attractive valuations in the municipal market, should foster strong demand for municipal bonds and contribute positively to their relative performance — even as the deteriorating economic environment pressures municipal budgets. We encourage investors to consider this asset class.

Investment Strategy

We maintained our strategic weight of 60% stocks/40% bonds for our balanced portfolio. Previously, we acknowledged there were substantial near-term downside risks for equities (weakening employment outlook, declining housing prices, continued deceleration in consumer spending, high oil/gas prices, and a lingering credit crunch). Although some of these risks have mitigated (oil/gas prices have fallen and the Fed and U.S. Treasury are aggressively battling the credit crunch), several others have worsened. Specifically, the employment outlook continues to weaken, and consumer spending likely will drop further. Equity valuations largely discount a worst-case scenario and are hesitant to assign much probability of success to the efforts of the Fed and U.S. Treasury. Therefore, we are holding our long-term strategic equity weighting.

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