

# Market Monthly

*An analysis of the economy and the markets*

NOVEMBER 20, 2006

## ■ *The Economy*

GDP growth of 2.6% and 1.6% for the second and third quarters, respectively, seems to indicate the U.S. economy has achieved a mid-cycle slowdown. The widespread housing-market correction has accounted for the majority of the slowdown and should continue to stifle growth for the next several quarters. Nevertheless, we believe the Federal Reserve remains overly concerned with inflation, thereby underestimating the impact the housing-market slowdown will continue to have on GDP. In the minutes from the last FOMC meeting, the Fed stated “the economy seems likely to expand at a moderate pace.” However, retail sales — which are tied to the status of the housing market — declined during October after downward revisions for August and September and most measures of inflation show the threat of rising prices is subsiding. Specifically, the Producer Price Index (PPI) fell by 1.6% during October, representing the largest monthly decline on record, while consumer prices (CPI) declined 0.5% for the second-straight month. In addition, the Core Personal Consumption Expenditures (PCE) index, Commodities Research Bureau (CRB) index, gold index and the GDP deflator have turned down. This should be welcome news to the Fed, as inflation is a lagging indicator. These statistics should give the Fed the latitude to move to a balanced risk assessment toward growth and inflation. Although the Fed may remain on hold for a while, we still believe the next move will be an easing, which most likely will occur during the first half of 2007. Currently, the futures market is anticipating a 50% chance the Fed will cut rates by its May 2007 meeting. We expect a change in tone from the Fed after its December 2006 meeting, with statements confirming the slowdown in inflation and recognizing the strong impact housing continues to have on economic growth potential. The recent elections, which captured center stage during the past month, tipped the balance of U.S. Congressional power in favor of the Democrats. But the advantage isn't so great as to dominate policy. Political gridlock seems a more likely outcome, which traditionally bodes well for financial assets.

## ■ *Equity Markets*

Stocks continued to advance against favorable economic and market news, with the consumer discretionary and technology sectors leading the way. In particular, slower economic growth, relatively contained inflation and low long-term interest rates, the continued pause in the Federal Reserve's rate-tightening campaign, and reasonable valuations among large-capitalization stocks contributed to a positive environment for equities. In addition, healthy balance sheets and strong free cash flows continued to promote various shareholder-friendly actions, including increased dividend payments, share buybacks and strategic acquisitions. 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, continues to put downward pressure on the U.S. dollar, which is yet another positive factor for large, multinational corporations. Since the end of the third quarter, the market's style preference has shifted from value to growth. On the down side, it most likely will take the prospect of the Fed easing to trigger any meaningful expansion among price/earnings multiples. In addition, although earnings growth remains healthy, the pace of that growth continues to moderate. Although declining energy prices have helped improve spending trends, consumer spending continues to face headwinds, particularly from the weakening housing market. Business spending remains robust, but probably is not strong enough to offset the entire decline in consumer spending. On the bright side, as the healthy pace of business and capital spending flows through the economy, companies benefiting from this trend should show stronger earnings growth. We believe several signs point to a continued-healthy, albeit slower-growth, environment. High-yield bonds, for example, currently are yielding less than their

historic norms, which may be an indicator of growth. The spread between TIPS (Treasury Inflation-Protected Securities) and Treasuries has narrowed considerably, underscoring the market's subsiding inflationary fears. In addition, continued strength in most commodity markets suggest a still-strong global economy.

### ■ **Fixed Income**

Since the last Market Monthly report (October 12), the bond market has remained bullish, with the yield on the two-year Treasury declining by eight basis points, the yield on the 10-year Treasury declining by 18 basis points, and the yield on the 30-year Treasury declining by 22 basis points. Slow economic growth combined with favorable inflation data — particularly from the manufacturing sector — helped maintain the rally. In our opinion, the bond market has a better sense of economic reality than the Fed. Continued weak economic data, lower inflation and eventually a cooperative Fed should prolong the bond market's gains. It's important to note, after each of the last three Fed tightening cycles, 10-year Treasury yields declined more than 100 basis points from the time of the last Fed rate hike to the first rate cut of an easing cycle. If history repeats itself, the 10-year Treasury may have only reached the half-way point of its rally. Thus, we suggest investors should maintain slightly longer-than-benchmark durations. With the Fed comfortably on hold, it appears we may be in a prolonged range-bound, low-volatility period. Outperforming in such an environment may come from an emphasis on income. It's important to remember more than 80% of fixed income returns come from the income component. As such, we believe investors should maintain a built-in income advantage over their respective benchmarks by overweighting mortgage and agency securities. We continue to underweight corporate credit, as corporations continue to take measures to enhance shareholder value at the expense of bondholders. We are constructive on the shape of the yield curve forecast. We expect short-term rates (less than five years) to be the major beneficiary of the next stage of the rally. The Fed has a direct impact on shorter-term rates, and as interest rate policy eases we should see the yield curve steepen. Therefore, we recommend an overweight in the two- to five-year portion of the curve. Looking ahead, if the Democrats remain true to their campaign promise of a “pay-as-you-go” scenario, the U.S. budget deficit should decline, creating a favorable climate for bonds. In addition, the likelihood of higher taxes under a Democrat-led Congress increases the attractiveness of municipal bonds.

### ■ **Investment Strategy**

Our recommended tactical asset allocation of 65% stocks/35% bonds remains unchanged. This allocation reflects our belief that longer-term market conditions should favor stocks over bonds. Slower economic growth, a likely slowdown in inflation, 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. Specifically, we continue to overweight large-cap stocks, due to their attractive valuations and the desire to maintain a more-defensive equity exposure.

*The opinions contained in the preceding commentary reflect those of BB&T Asset Management, Inc. and not those of BB&T Corporation or its executives. The stated opinions are for general information only and are not meant to be predictions or an offer of individual or personalized investment advice. They also are not intended as an offer or solicitation with respect to the purchase or sale of any security. This information and these opinions are subject to change without notice. Any type of investing involves risk and there are no guarantees. BB&T Asset Management, Inc. does not assume liability for any loss which may result from the reliance by any person upon any such information or opinions.*

*Investment advisory services are available through BB&T Asset Management, Inc., a subsidiary of BB&T Corporation. BB&T Asset Management manages customized investment portfolios, provides asset allocation analysis and offers other investment-related services to affluent individuals and businesses. Securities and other investments held in investment management or investment advisory accounts at BB&T Asset Management are not deposits or other obligations of BB&T Corp., Branch Banking and Trust Company or any affiliate, are not guaranteed by Branch Banking and Trust Company or any other bank, are not insured by the FDIC or any other government agency, and are subject to investment risk, including possible loss of principal invested.*