Investment Intelligence®

Market Monthly

An analysis of the economy and the markets

BB&T ASSET MANAGEMENT

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The Economy

Following the announcement of President-elect Obama's economic team, the stock market posted its best one-week rally since 1984. We were pleased with the naming of New York Federal Reserve Governor Tim Geithner as Treasury secretary. Geithner is very familiar with the financial markets and has experience working with current Federal Reserve Chairman Ben Bernanke and former Chairman Alan Greenspan. Economic data remain weak, which likely will prompt the passage of another stimulus package. The Federal Reserve is maintaining its "whatever it takes" approach to help resuscitate the economy and financial markets. Recently, the Fed switched from targeting housing-related assets to focusing on consumer-related assets through direct investments in agency, mortgage-backed securities and asset-backed securities (auto, credit card, home loans). Rather than working through banks, the Fed focused directly on private borrowers, with the ultimate goal of reducing credit spreads and driving down mortgage borrowing costs. Early results were positive, as 30-year fixed-rate mortgages fell below 5.5%. The Fed, European Central Bank and Bank of England remain committed to their coordinated global central bank easing campaign targeting the global financial market crisis and economic tailspin. Other countries, including Germany and China, recently implemented their own stimulus packages. Investors have been concentrating more on fundamentals and the economy, which is experiencing rising unemployment, slowing manufacturing, consumer retrenching, weak stock prices, wide credit spreads, tight lending standards and low confidence levels. Holiday spending appears sluggish, and although consumers are getting a big break at the gas pump, falling oil prices are not enough to offset the recessionary conditions. The deflationary aspects of the financial crisis and deleveraging process are panning out, as indicated by falling prices for oil, steel, wheat, corn, and other commodities, and by still-retreating home prices. Together, these lower prices will help dramatically drive down inflation in the coming months. Recently, the Core PCE (Personal Consumption Expenditures) Index slipped to 2.1%, close to falling within the Fed's target range of 1% to 2%.

Equity Markets

Corporate financial reports confirm a sharp global recession is underway. We remain concerned about companies with high fixed costs and operating leverage. As revenues continue to slide, such positions can create large cash losses. The government's decision to extend protection to the commercial paper markets has tempered our concerns about short-term business funding needs. Companies enjoying stable demand for their products and those that are internally financed should weather the storm reasonably well. As stock prices correct, we 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 Federal Reserve has become much more aggressive lately, pursuing a broad-based strategy rather than the ad hoc approach it practiced earlier. Although the Fed's policy response has improved interbank lending rates and the commercial paper market, it has yet to overcome the financial crisis. As long as credit spreads remain historically wide, the global economy continues to decline, and the deleveraging process unfolds, investors likely will remain risk-averse. Furthermore, consumer spending will continue to deteriorate, led by the struggling housing market, elevated commodity costs, weak income growth, mounting job losses, the need to rebuild savings, and wider credit spreads. With the credit crisis intensifying overseas, the European economies have deteriorated sharply. They likely face a greater challenge due to the difficulty in creating a coordinated, continent-wide solution and also because their central banks were slow to cut interest rates. Therefore, the European currencies have little upside potential versus the dollar and likely will weaken further. On a positive note, home sales have started to increase in response to lower home prices, and home inventories have started to retrench. Together, the Fed's quantitative easing strategy and a new plan to push mortgage rates toward 4.5% represent the groundwork for home prices to stabilize. When home prices stabilize, the banking system can heal. And when the banking system heals, the credit markets will thaw. Equity valuations largely discount a worst-case scenario, implying a low probability of success to the federal government's all-out efforts to solve the credit crisis and restore economic growth. We believe these efforts eventually will work and are therefore maintaining our long-term strategic equity weightings across all portfolios.

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Fixed Income

The commercial paper market is starting to function again, because the Federal Reserve is buying and guaranteeing debt. But, private capital investments remain scarce. Libor (London interbank offered rate) is falling, as the coordinated global central bank efforts are taking hold. After easing 50 basis points to 1% in late-October, the Fed indicated it may lower the target rate to 0.5% at its December monetary policy meeting (actual rates are already close to zero). The European Central Bank cut rates another 75 basis points to 2.50%, and the Bank of England lowered rates an additional 100 basis points to 2%. These actions are necessary to foster broader improvements in the financial markets. Nevertheless, deleveraging remains the key to widespread relief, and it's not yet clear how much farther this process has to go. Treasuries remain the best-performing fixed-income asset class so far this year. With the Fed now targeting mortgage-backed securities (MBS), asset-backed securities (ABS), and direct government-sponsored entity (GSE) debt, credit spreads are narrowing dramatically. Spreads on MBS, for example, recently contracted by 75 basis points, suggesting the worst may be behind us for U.S. agency debt and agency-backed MBS. We are currently purchasing both sectors. On the other hand, spreads on investment-grade corporate bonds recently topped 600 basis points, while high-yield spreads surged to more than 1,835 basis points. This is a clear sign the bond market does not expect any good economic news in the near future. We will continue to monitor spreads in hopes of confirming a turning point. We will consider adding short-term credit with wide breakeven spreads and select higher-quality names better insulated from a weak economy. There is a chance the Fed eventually will start buying corporate bonds to help reduce borrowing costs. Municipal bonds underperformed in October, as Moody's downgraded the remaining AAA-rated insurers (FSA, AGO) to AA. In addition, Treasury notes rallied further, causing hedge funds to sell municipal securities into margin calls. This led to the steepest municipal yield curve since 1984 and record municipal/Treasury ratios for portions of the curve. In addition, the relative performance of municipal securities has suffered because municipalities have not received any government support or bailout attention. Barack Obama's presidential victory and the Democrats' dominance in Congress suggests marginal tax rates will be higher in the future. Higher taxes, combined with attractive municipal valuations, should foster stronger demand for municipal securities and better relative performance, even as the weak economic environment puts pressure on municipal budgets. Investors should consider adding exposure to municipal securities.

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, deteriorating housing prices, continued deceleration in consumer spending, high oil/gas prices, and the 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 decline 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. We believe success is on the horizon and therefore, we are holding our long-term strategic equity weighting.

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