

Market Monthly

An analysis of the economy and the markets

DECEMBER 2007

■ **The Economy**

The continued housing-market decline—and the related impact on consumers—remains an impediment to economic growth. According to the S&P/Case-Shiller composite, home prices are down 4.9% from a year ago, and the price drop continues to accelerate. The last housing market correction, which occurred in the early 1990s, lasted three years. Analysts estimate the current downturn could last longer—at least another two years—and finish with prices falling 10% or more. On a positive note, we remain constructive on the inflation outlook. Financial crises historically have led to slower growth and lower inflation. We expect the current crisis will be no different. Elevated oil prices, which recently have prompted inflation fears, have more to do with the weaker dollar (oil is traded in U.S. dollars) than mounting inflation. With owner's equivalent rent making up 40% of the inflation data, and given the current state of the housing market, we don't expect inflation to rise. Jobless claims—another critical indicator—have risen recently, but the pace of the increase has not yet threatened the economy. As long as jobs are available, the economy likely will avoid a recession. We will continue to monitor the jobs data closely over the next several months. The Federal Reserve remains in a reactive mode, rather than a proactive position, indicating it will respond to continued financial market turbulence in an effort to thwart any additional economic fallout. As such, we anticipate additional rate cuts combined with the Fed altering its stated risk concerns from heightened inflation to economic weakness. We believe the Fed's actions, as long as they occur in a timely fashion, will keep GDP growth in positive territory.

■ **Equity Markets**

The credit crunch continues to dampen economic growth prospects. Furthermore, credit spreads continue to widen, asset-backed commercial paper continues to struggle, and the ongoing subprime debacle continues to block transparency. Several private equity and hedge funds have created distressed investment vehicles to purchase mortgage assets, but only a few of them are buying subprime assets. If the Fed maintains its easing campaign, we believe the economy may avoid a recession. In this scenario, long-term earnings growth should remain healthy. Nevertheless, near-term earnings results appear to be at risk for all but the global, multinational companies, which should continue to benefit from a falling U.S. dollar and global economic strength. With reasonably healthy balance sheets and strong free-cash-flow, corporations still have the flexibility to pursue shareholder-friendly actions, including raising dividends, repurchasing shares and, pending the resolution of the liquidity crunch, making accretive acquisitions. The U.S. consumer continues to show remarkable resiliency, despite the headwinds of high energy prices, low housing affordability, a weak housing market and tighter lending standards. Spending on the business side has slipped recently, but the falling U.S. dollar has provided a lift to U.S. exports. The U.S. trade deficit, relatively slower economy, and the shrinking short-term interest rate differential for the United States relative to the rest of the developed world continue to put downward pressure on the dollar. However, a weaker dollar should benefit multinational companies on a relative basis, assuming the weakening remains orderly. 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 credit markets experienced another downturn in November, as investment-grade spreads widened an additional 40 basis points and high-yield spreads widened 140 basis points. Liquidity concerns resurfaced, and the credit-derivative and mortgage markets suffered additional losses. Treasury securities once again led the bullish charge, as two-year Treasury yields plunged more than 90 basis points and 10-year Treasuries declined 50 basis points. With investment-grade corporate bonds spreads approximately 190 basis points above Treasuries, we believe it's time to invest in the corporate sector again. "Breakeven" spreads now are 30 basis points, which mean spreads would have to widen an additional 30 basis points each year to underperform Treasuries. At this level, we believe the odds have

shifted to our favor. Municipal bond valuations remain attractive, with maturities of 10 years and less trading at more than 90% of Treasury yields. Investors continue to enjoy the lower volatility and relative “safety” of the municipal market. In addition, the odds of higher marginal income tax rates from the upcoming 2008 elections increase the attractiveness of tax-free bonds. In terms of interest-rate exposure, we favor portfolio durations that are neutral to slightly longer than their benchmarks. We also recommend maintaining overweights to agency, municipal and mortgage-backed bonds, and moving toward a more neutral position to high-grade corporate bonds. We suggest underweighting Treasuries, because yields already reflect an anticipated fed funds rate target of 2.5%. Indeed, investor emotions ultimately could push rates even lower, but we do not believe there is enough fundamental weakness to justify these rates for the long-term. Bond insurers MBIA, Ambac and Radian were the latest to come under pressure from losses in the mortgage and CDO markets. Year to date, their share prices have tumbled 50% to 80%. If the losses prove large enough, we are concerned that the AAA ratings and/or claims-paying ability of these insurers could come into question. We expect these insurers will strive to maintain their AAA ratings, but these recent events reinforce our strategy of buying bonds based on the underlying quality rating rather than insurance protection.

■ **Investment Strategy**

We are maintaining a tactical asset allocation of 65% stocks/35% bonds for our balanced portfolio, reflecting our belief that longer-term market conditions should favor stocks over bonds. We continue to focus on higher-quality securities, particularly the stocks of financially strong companies with reasonable earnings-growth prospects. The ongoing liquidity crisis could create a variety of stock-specific investment opportunities for companies enjoying strong cash positions. With global economic growth likely to outpace U.S. growth, we believe multinational companies should benefit on a relative basis.

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