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BERKS COUNTY
REAL ESTATE &
DEVELOPMENT
SYMPOSIUM 2017
A PROGRAM OF LEHIGH VALLEY BUSINESS

Economic
Review and Outlook

Jim King
Chief Investment Officer
BB&T Institutional Investment Advisers

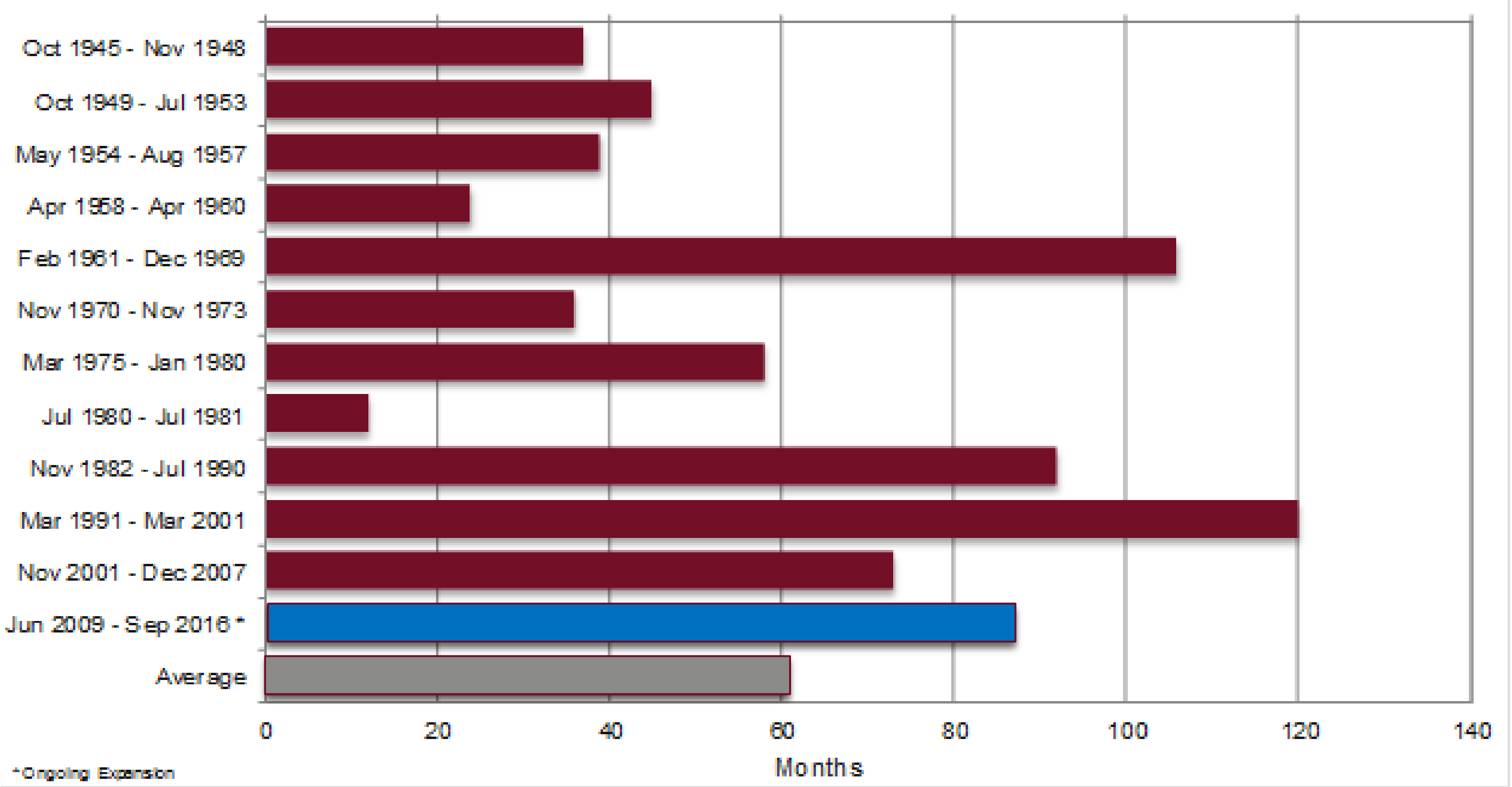
Agenda for today:

- **Economic Overview**
- **Equity market returns YTD 2017**
- **Federal Reserve Policy and Interest Rate Outlook**
- **Domestic and International Growth**
- **Labor markets and inflation**

First, let's turn back to what we considered last year …..

Fall 2016: we observed the near-record expansion …..

Past Economic Expansions - - Where are we now?



Sources: Reflects BB&T IIA's calculations based on data from Bloomberg LP.

At 7.3 years, the expansion was already the 4th longest since WWII.

….. and discussed why we expected it to continue

The expansion does appear different this time

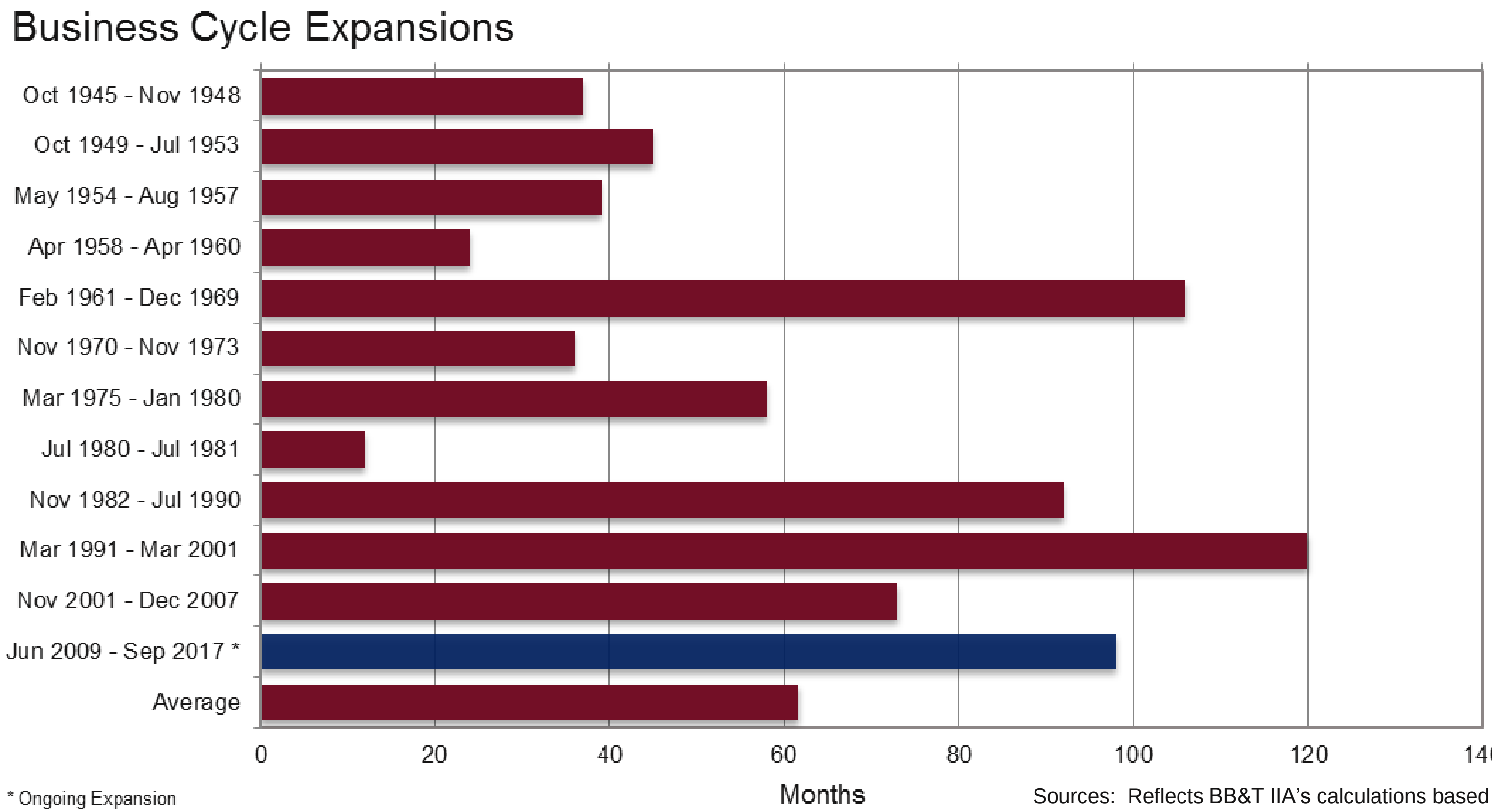
Top 4 Business Cycle Expansions	Months	Years	CPI Avg.	Effective Fed Funds Rate	Neutral Fed Funds Rate	Annualized GDP	Productivity
April 1991 - March 2001	120	10.0	2.8%	5.0%	2.2%	**3.5%**	**2.3%**
March 1961 - December 1969	106	8.8	2.4%	4.3%	1.9%	**4.7%**	**3.0%**
December 1982 - July 1990	92	7.7	3.7%	8.3%	4.6%	**4.1%**	**2.2%**
July 2009 - September 2016 *	87	7.3	1.5%	0.2%	-1.4%	**1.8%**	**0.9%**
Federal Reserve Long Run Projection			2.0%**	2.9%	0.9%	**1.8%**	**n/a**

* Current expansion is ongoing **Fed's Preferred inflation measure: PCE Deflator
Sources: Reflects BB&T's calculations based on data from NBER, Federal Reserve Bank, Bureau of Labor Statistics, and World Bank.

Despite its length, this expansion looked far different from previous ones: low inflation, low interest rates, and slow growth, suggesting longer duration.

Today: Absent a shock to the system we expect continued growth over the coming quarters.

Moving towards another record



* Ongoing Expansion

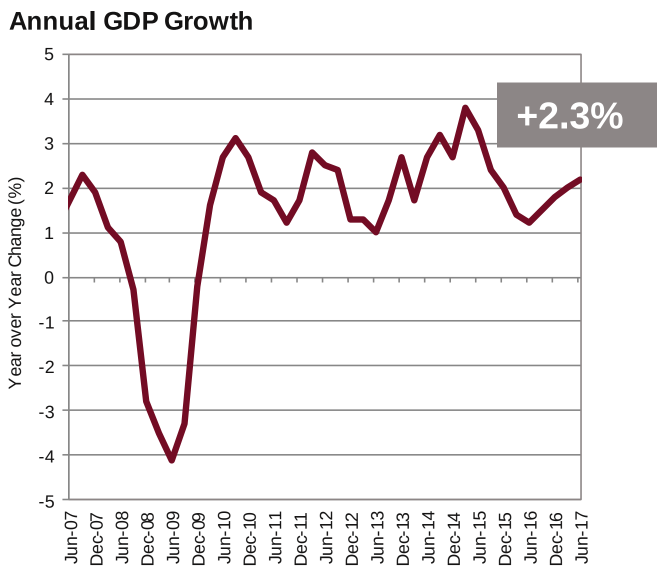
Sources: Reflects BB&T IIA's calculations based on data from Bloomberg LP.

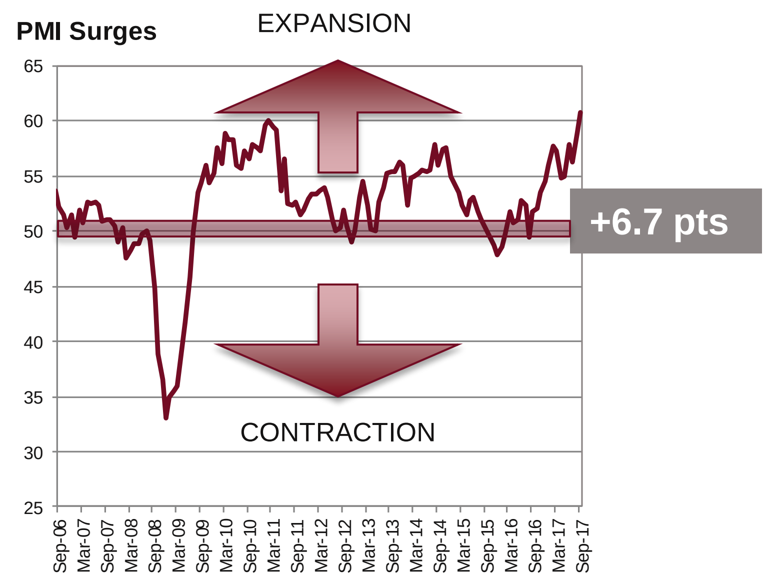
In fact, now at 8.4 years, we could be in the longest expansion in U.S. history back to 1854.

According to a New York investment firm:

- The risks of recession are 35% in the next year and rising.
- Of course, that means they view the chance of continued expansion at 65%!
- Current data supports the latter.

Healthy U.S. Economy – Optimism Abounds





Sources: Bureau of Economic Analysis, Institute of Supply Management

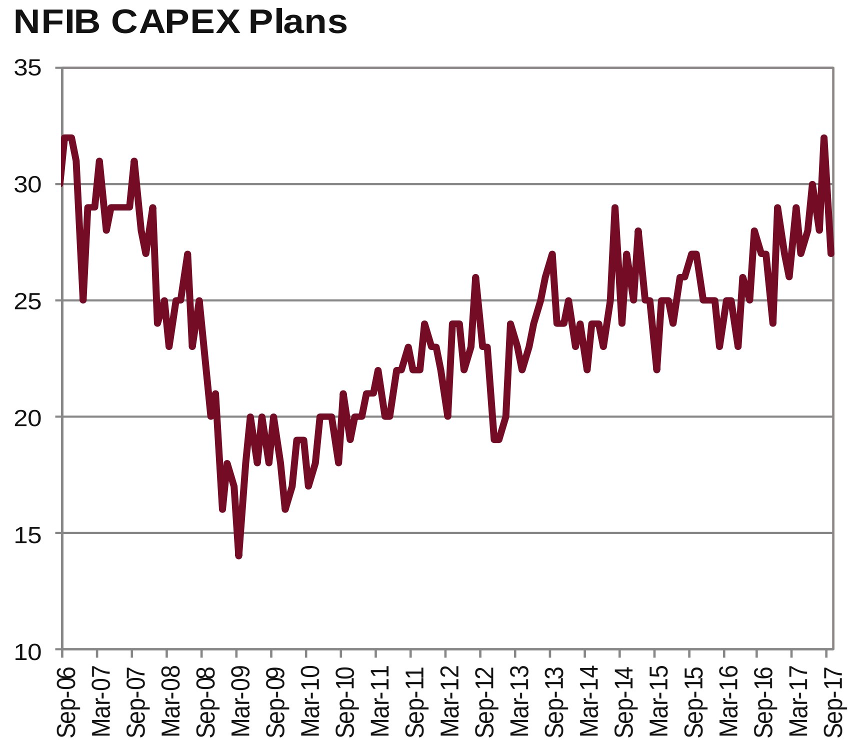
The U.S. economy is performing well, boosted by consumer and business fixed investment – which represent 85% of GDP

- GDP 3Q17 +3.0%, YoY +2.3%
  - ✓ Consumer +2.4%
  - ✓ Business Investment +3.9%
- Institute of Supply Management's Purchasing Managers' Index (PMI) reached its highest level since 2004, driven by increases in new orders and production and a backlog of orders and jobs-to-be-filled

Healthy U.S. Economy – Optimism Abounds

Small Businesses Continue to Be Optimistic

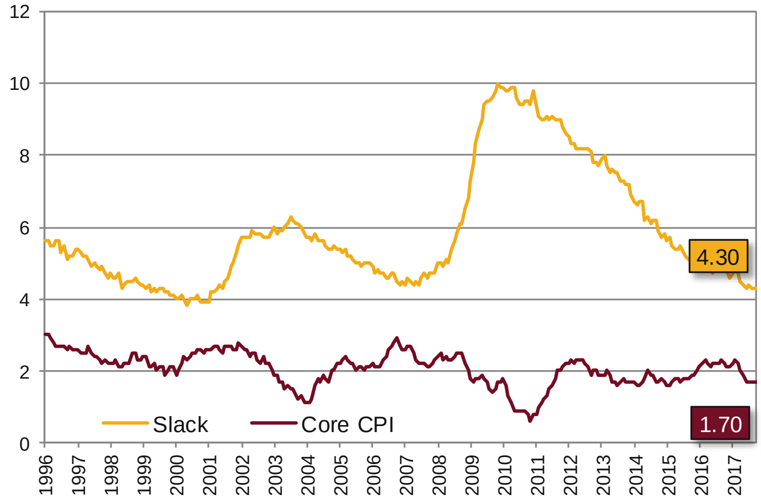
- Small businesses, as represented by the NFIB, showed strongest plans to increase capital spending in August since 2006
- Small businesses represent 99.9% of all U.S. businesses and employ 48% of the workforce (58 million)
- Tax reform should benefit small businesses which often pay 35% or more in corporate taxes



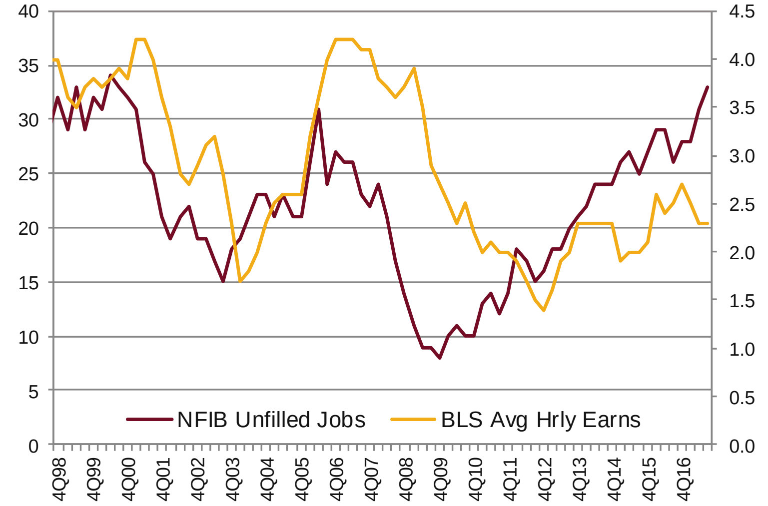
Sources: National Federation of Independent Business

Healthy U.S. Economy – Working Off Labor Slack – Wage Pressures Present

Labor Market Slack Caused Inflation to Lag Traditional Phillips Curve Relationship



Unfilled Jobs lead Wages



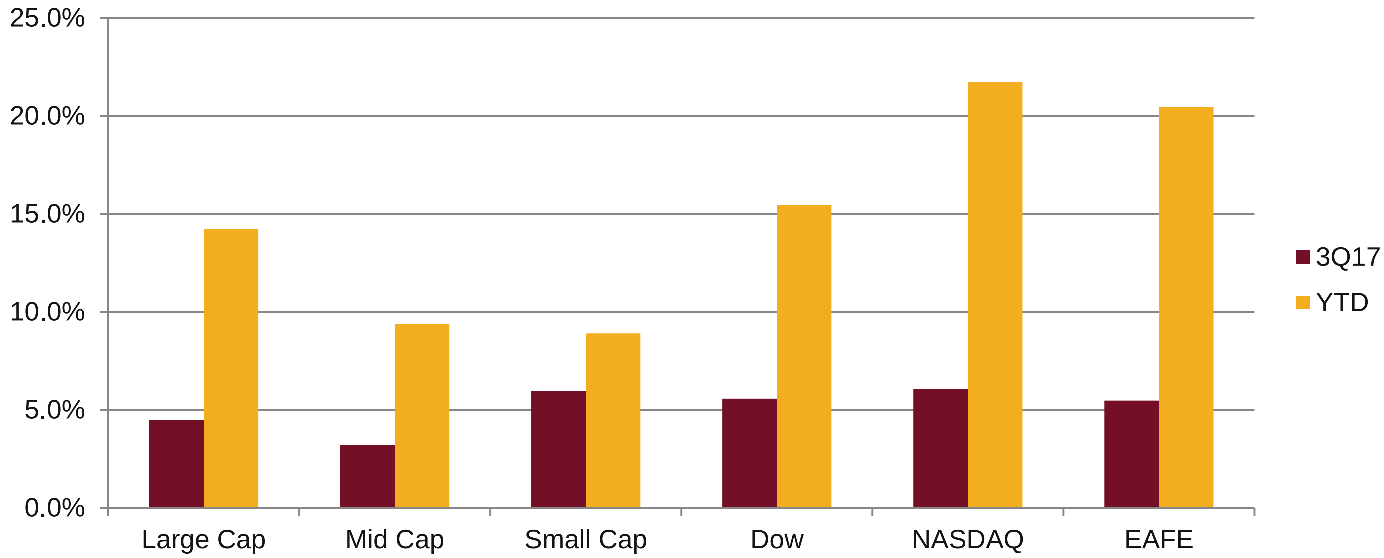
Sources: Bloomberg L.P., Bureau of Labor Statistics, Federal Reserve, National Federation of Independent Business,

Years of outsized slack in labor market finally worked its way out – anecdotal evidence of labor shortages and wage pressures

- Historically, increases in the NFIB Unfilled Jobs measure lead to a rise in wages (Average Hourly Earnings)
- Recent disconnect likely due to massive excess slack in labor market post-financial crisis
  - Labor market slack captured in differential between Under-employment and Un-employment
  - Historical difference : 4 to 5 percentage points. Surged to 5 to 10 percentage points years following recession

The ongoing, positive economic activity is one factor promoting higher stock valuations….

3Q17 Marks Another Positive Quarterly Performance …

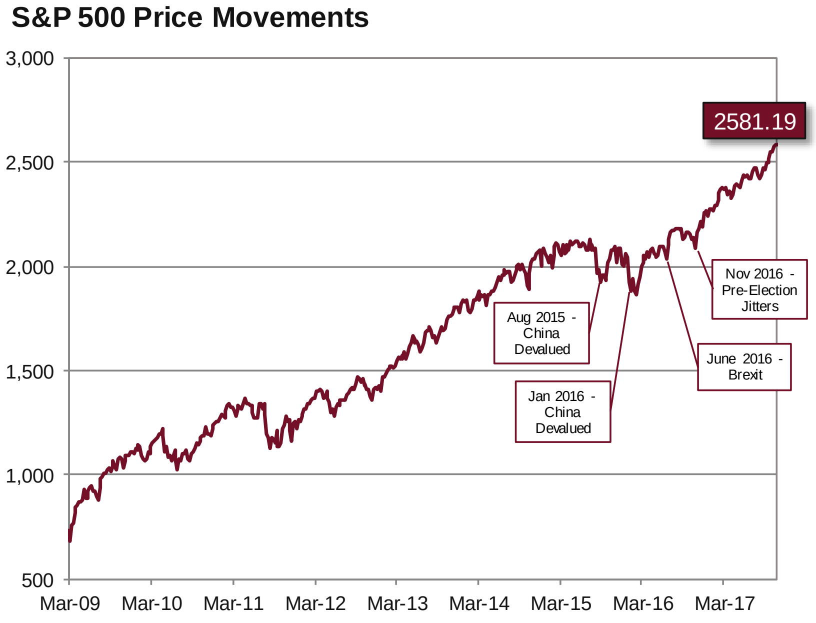


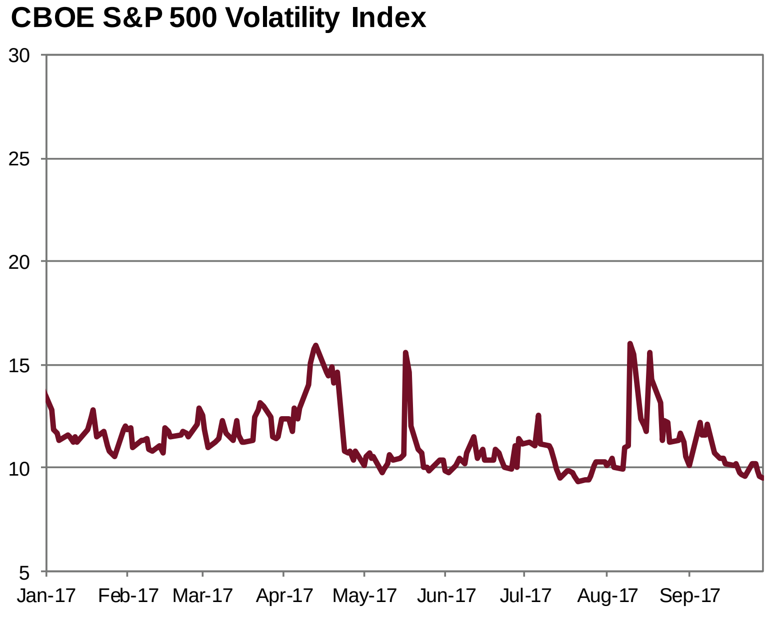
Sources: Bloomberg L.P., S&P Dow Jones, NASDAQ, MSCI

Despite ongoing uncertainty regarding political infighting, fiscal policies, the federal reserve, interest rates, and geopolitical tensions, broad equity markets turned in another positive quarterly performance

- S&P 500 – new record high closing levels 48 times this year through October
- Dow Jones Industrial Average broke new 1000 point levels 4 times so far this year - - double the previous record!
- Larger company stocks continued to lead the U.S. markets for the year, however small caps had a significant boost in the third quarter on hopes for a corporate tax cut that would benefit small business owners

U.S. stock prices have moved higher with surprisingly little reaction to global events





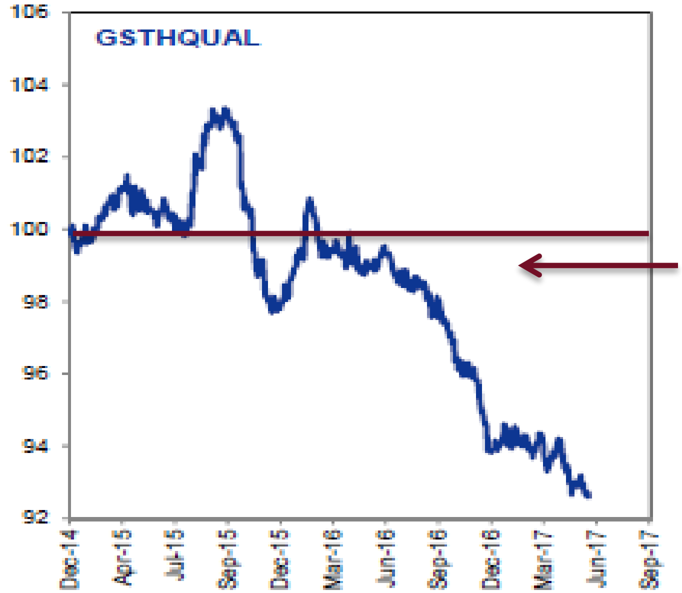
Sources: Bloomberg L.P., CBOE, Federal Reserve, S&P Dow

U.S. Bull Market, at 8 ½ years, is second longest since 1990's

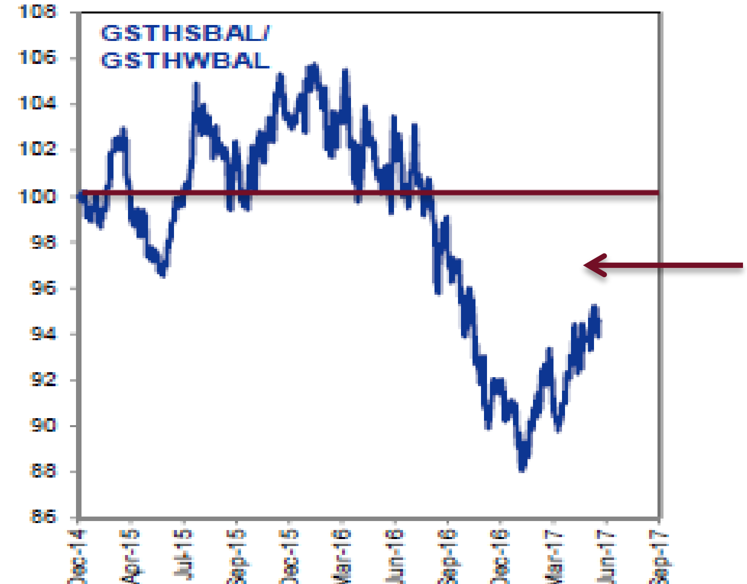
- S&P 500 – up 18 of last 19 quarters
- Last daily 3% correction occurred LAST November – biggest gap since mid-1990's
- Volatility at its 25-year historical low

We appreciate the stock gains but are concerned about investor complacency and ignoring risk

High Quality



Strong vs. Weak Balance Sheet



Sources: Goldman Sachs Global Investment Research

High quality companies – safe balance sheets, stable sales growth – are underperforming the overall S&P 500

- The **High Quality** basket includes stocks with safe balance sheets, high and stable sales growth, low propensity of EBIT decline, low stock drawdown risk, ROE above peers, and higher dividend yields
- The **Strong vs. Weak Balance Sheet** chart shows the performance of a relative index where the numerator is a basket of stocks with strong balance sheets and the denominator is a portfolio of stocks with weak balance sheets

We appreciate the stock gains but are concerned about investor complacency and disregard of risk

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Russell 3000 Companies with:

Positive Earnings*: **+ 12.2% YTD**

Negative Earnings*: **+ 24.8% YTD**

The Russell 3000 Index represents 98% of all investable U.S. equities.

**Companies with +/- earnings determined based on most recent trailing-twelve-month earnings. Performance returns through September 30, 2017.*

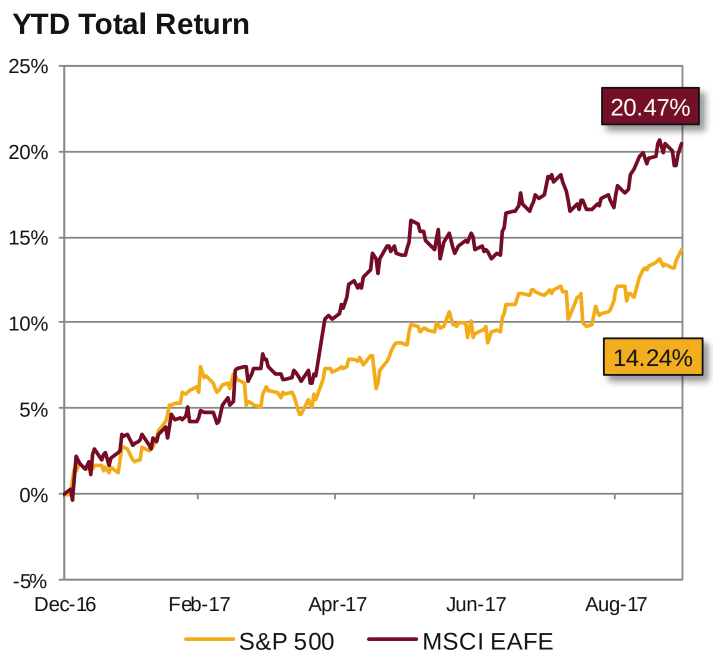
Source: Russell

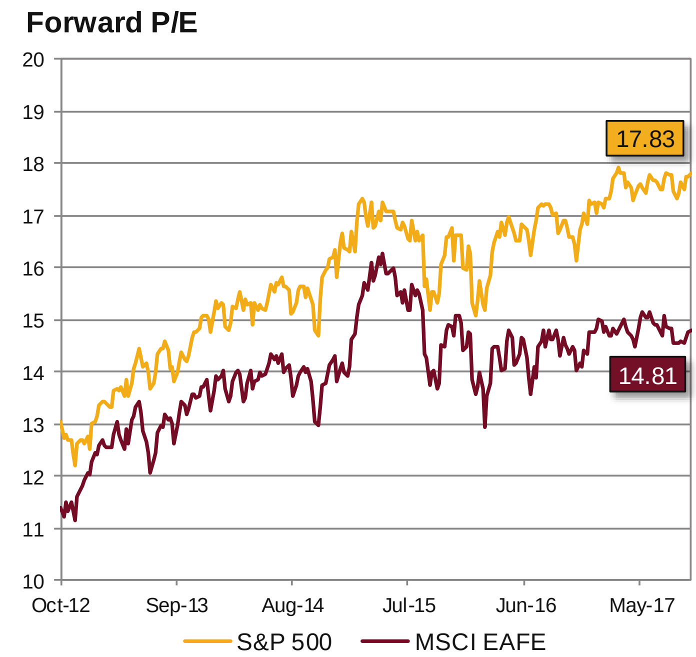
Companies with poor financials are not penalized resulting in inadequate compensation for risk

- Companies ***losing*** money have recently outperformed those ***making*** money
- A brief, flight-to-quality market decline in August brought a reminder of risk management importance:

	7/25/17 – 8/21/17:
Companies with Positive Earnings*	-5.1%
Companies with Negative Earnings*	-9.0%
Volatility (VIX)	+39%

We finally see strong opportunity for gains in foreign stocks.



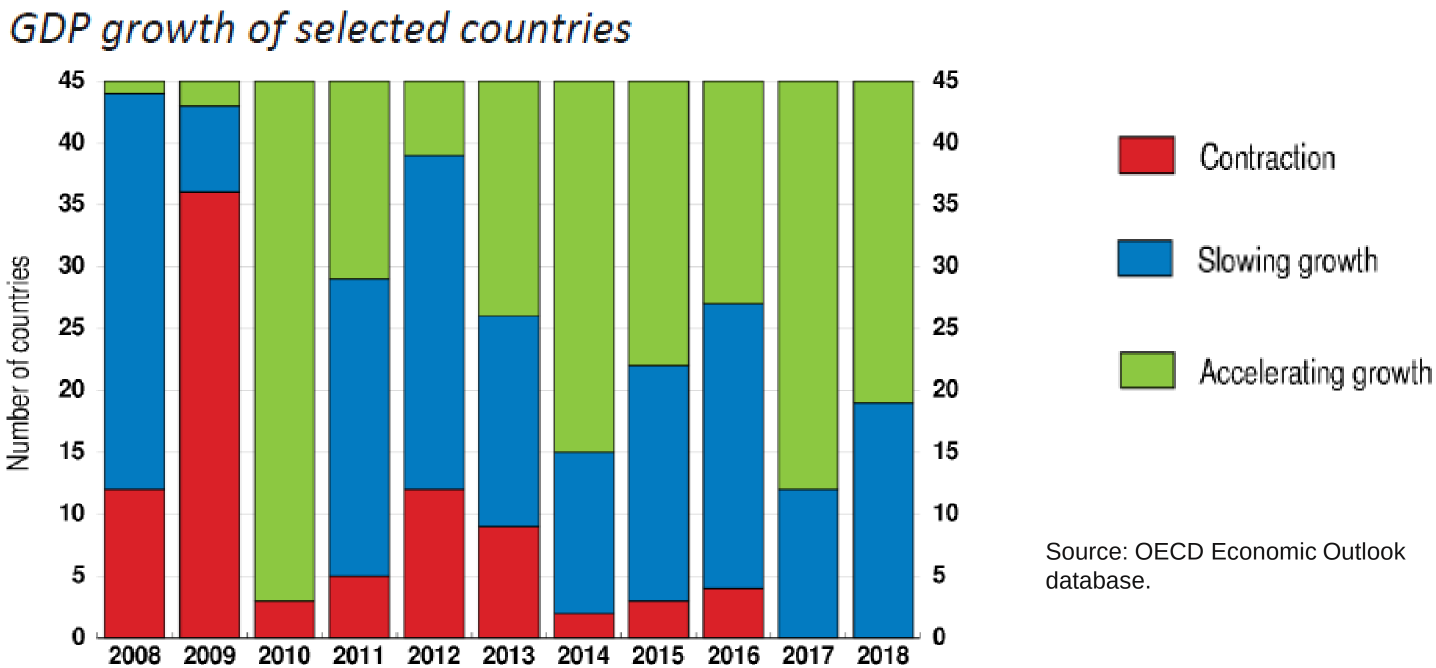


Sources: Bloomberg L.P., S&P Dow Jones, MSCI as of September 30, 2017

International stocks have outperformed this year after years of underperformance yet we believe they remain relatively attractive.

	Foreign - MSCI EAFE	U.S. -S&P 500
Performance 2006 to 2016 (Annualized):	1.3%	6.9%
P/E Ratio – 20-yr Average	26.2x	19.5x

Synchronized Global Growth Provides Support for U.S. Earnings

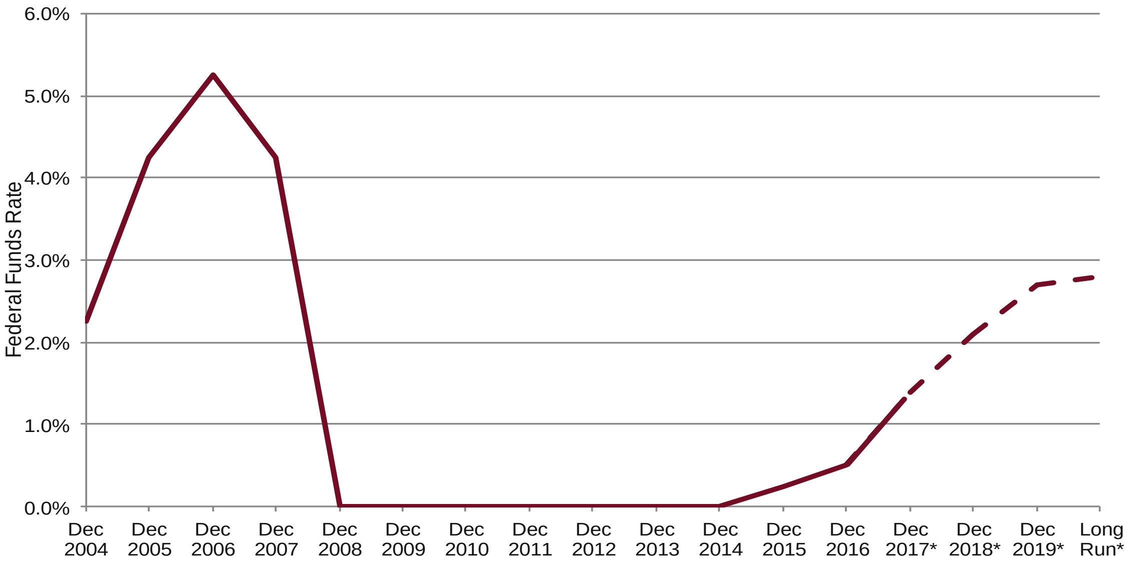


Source: OECD Economic Outlook database.

For the first time since 2007, all 45 countries tracked by OECD are on track to grow in 2017 and expected again in 2018

- Countries benefited from easy monetary policies from global central banks since 2008 and the ancillary effects of lower energy prices
- Simultaneous growth among all OECD countries is rare
- U.S. companies' earnings growth stands to benefit: 35% of S&P 500 revenues comes from overseas

Federal Reserve Removing Accommodation



* indicates Fed's expectation as of September 2017

Federal Reserve committed to normalizing interest rates after years at 0%

- Fed Chair Janet Yellen emphasized (Sept. 2017) that monetary policy remains accommodative and has a lag effect. *"We want to be careful not to let the economy overheat"* *"We continue to expect to gradually increase rates"*
- **FOMC projections expect one more rate hike in 2017, three in 2018**
  - Current Long-run neutral rate (2020 and beyond): **2.80%**
  - 2012 Fed Projection: **4.25%**

Federal Reserve Removing Accommodation

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Federal Reserve Balance Sheet $4.5T

- Treasuries and Mortgage Backed Sec's
- Amounts to Roll Off Not Reinvested:

4Q17:	$10B/month
1Q18:	$20B/month
2Q18:	$30B/month
3Q18:	$40B/month
4Q18 and thereafter:	$50B/month

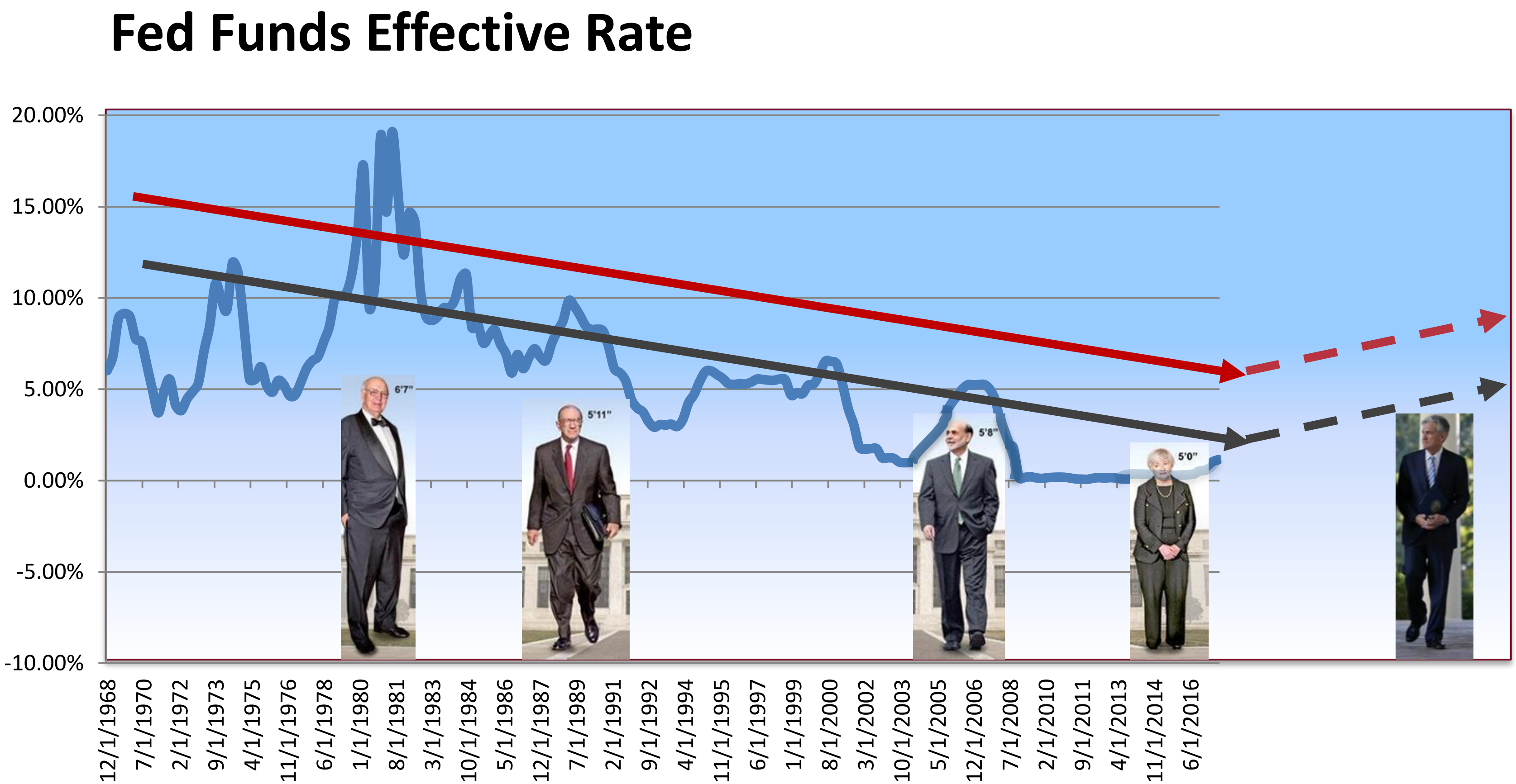
- Treasury maturities in 2018: $419B
- Amount of Treasuries to Roll Off: $250B

Sources: Federal Reserve

Unprecedented unwinding of the Fed's balance sheet and changeover on the Fed's Board have broad implications for interest rates and monetary policy.

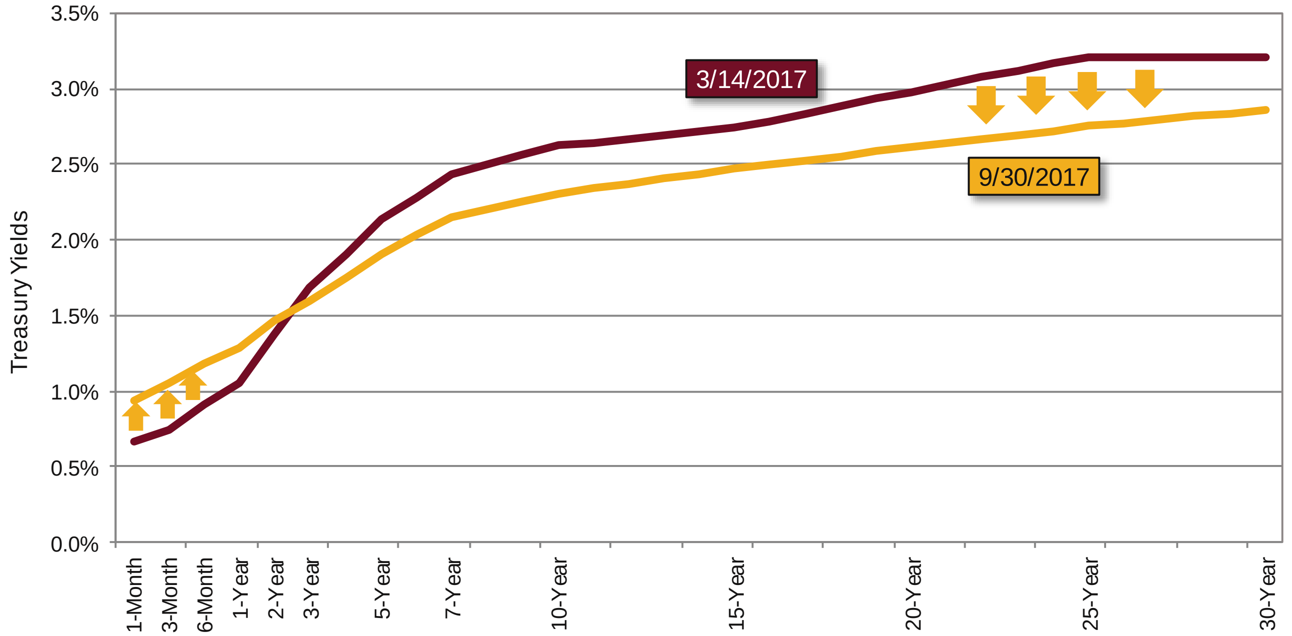
- 60% of 2018 Treasury maturities will not be reinvested
- Extraordinary shake up on the Federal Reserve Board:
    - Currently three (of seven) vacancies and one newly added governor with a background in Treasury and hedge funds
    - Chair Yellen's term will expire February 2018 – to be replaced by existing Fed governor Jerome Powell
    - How will the change in the Fed leadership affect rates?

Interest Rates Since 1968



It seems conclusive that higher rates are coming under Jerome Powell! This outlook is consistent with current Fed policy.

Bond Market: Still Skeptical of Fiscal Success, Unconcerned by the Fed



Sources: Bloomberg L.P.

Despite the Fed raising rates 50 basis points year-to-date, and another increase expected in December, longer rates have declined

- The 2-year U.S. Treasury yield typically rises in tandem with the Fed's tightening but is nearly unchanged since the eve of the March 15 rate increase
- The decline in long term rates suggests little concern for future inflation
- As the Fed unwinds its balance sheet, yields should face upward pressure based on supply/demand

SUMMARY:

- The U.S. Economy remains healthy with full employment and steady growth. Despite the protracted expansion it appears to have legs. All benefit from synchronized global growth for 2017 and 2018. Be mindful of wage inflation despite low overall inflation pressures.
- The extended Bull Market has left U.S. stocks at full valuations with reduced opportunity for significant future gains. Foreign stocks have finally responded to economic recovery and remain good relative values due to years of underperformance.
- The Federal Reserve is likely to continue gradually raising rates and removing accommodations; other Central Banks will maintain stimulus.
- Markets are not paying adequate attention to risk and future volatility. Investors should remain prepared for political disappointments, international crises, or other unexpected events.

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