

INVESTMENT INSIGHTS: AUGUST PODCAST

WITH BRETT HAMMOND

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Chief Investment Strategist Brett Hammond discusses the economic slowdown, the measurement of financial security, and recent market events.

Hello and welcome to August's edition of TIAA-CREF Investment Insights. Today is August 16th. I'm John Wilkens and, as usual, we're joined by Brett Hammond, TIAA-CREF's Chief Investment Strategist. Brett, even though the second quarter ended in June, we're seeing some downward revisions of the actual economic growth estimates for that period.

Yes. Overall economic growth or GDP was initially estimated by the government at about 2.3%. Now, with new information about imports and exports, as well as industrial production, our estimate is that GDP during the second quarter grew less than that, probably in the range of about 1.5% on an annualized basis.

This seems like a pretty big change. Doesn't it raise the question though of whether we need to look beyond the usual market indicators? One of the things we often talk about is market indexes – or indices if you prefer. But more and more, we're seeing other non-market – let's go with indexes – being reported with some frequency. The VIX – implied volatility of the S&P 500 – comes up a lot when the markets are gyrating, Consumer confidence is another.

Driven of course by the issues of the day. Consumer spending remember is about two thirds of all economic activity. But government stimulus spending will have peaked over the summer. The still missing component is consumer spending. Which, factoring in nearly 10% unemployment, remains low.

And this is the reason why Consumer Confidence numbers get discussed a lot these days. They measure consumers' feelings about the economy. They're an imperfect predictor of how much consumers will spend in the near future, but they can provide a rough directional sense of consumer spending patterns.

So turning to actual consumer expenditures, you've said before that spending fell in the first half of 2009, but since then it's been positive, but low.

1.6% growth in the second quarter of this year. But a corollary to the low spending is an increase in personal saving.

Which would stand to reason. What's not spent is saved.



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And here we have to separate the economic viewpoint from the social welfare perspective. We call it the paradox of thrift. It's great that people are on average saving more. As a society we need that.

But on the other hand though, the economy needs spending to increase demand, put people back to work and continue to grow. You said consumer confidence is a decent directional indicator Brett.

Well there are valid reasons why it's looked at so closely. But there's been a lot of very interesting work done in this area recently. A group from the Rockefeller Foundation lead by an economist from Yale called Jacob Hacker unveiled a new measure to gauge economic hardship called the Economic Security Index, or ESI. Essentially the ESI model measures the percentage of U.S. households whose income has dropped by 25% or more from one year to the next.

Which one assumes is a drop that's very hard to replace.

The thing that's especially interesting is that the ESI combines factors that individually have led to economic hardship but all too frequently these days can happen simultaneously – the loss of a job, large, frequently unexpected healthcare bills not covered by insurance, and a lack of savings to meet their overall obligations. By measuring across these areas, what they've done is combine the key drivers of income decline into a single measure of economic security.

But what's the practical implication here?

Look at it this way. If an increasing percentage of Americans have actually experienced a drop of 25% or more in income for whatever reason, we know then that they are experiencing real economic hardship. We're not talking about consumer confidence so much as consumer reality. Importantly, this distinction hasn't always been self evident from other data.

For example?

Well the study we're talking about cites that in 1992, the poverty rate and the unemployment rate were higher than in 2002, but the Economic Security Index was actually more negative in 2002.

So you're saying there was more real hardship in 2002 than in 1992 even though unemployment was lower and fewer people were living below the poverty level in 2002.

Right. Not only that but according to their work, economic insecurity has actually been rising rather steadily for 25 years and it continues to do so. Current market conditions are one thing, but what this long-term index does I think is provide very valuable insights into the realities that impact all of us to varying degrees – and it helps identify groups that have been hurt the most.

This information's valuable to me as a market strategist, but will be especially valuable to America's policy makers. We need to continue to search for the right solutions to sustain recovery but also to address what we now know to be a 25-year erosion in economic security for far too many Americans.

Brett let's stay on the theme of recovery. The Fed Open Market Committee left the Fed funds rate unchanged at practically zero on Tuesday the 10th. Surprising absolutely no one. But any thoughts on their statement?

Well, they were decidedly blunt about the slowing pace of recovery in output and employment. And a little bluntness is a good thing right now. What this signals to me is that the Fed is going to continue to do whatever it can to keep us on the right track – if needed.

One of the actions the Fed took was to reinvest roughly \$100 billion from maturing debt back into longer-term securities.

In terms of the overall market though, it's not a large move given that Government debt repurchases have run into the trillions. The immediate impact was an increase in debt prices and a corresponding decline in yield. I think the 10-year Treasury hit 2.76%, the lowest level since December of 2008.

But the issue isn't just the immediate impact. Like many things the Fed does and says, it signals a willingness to take whatever steps are needed to keep recovery on track.

What about overseas?

Well we also saw June's trade deficit widen. Imports increasing relative to exports to about \$50 billion. Worse than was expected as economies overseas have slowed as well. What it means for us is that we can't rely on exported goods to drive growth as much as was anticipated.

Brett you'd mentioned that stimulus spending has peaked. Between that and Fed Chairman Bernanke's comments, should we now be worried about a double dip?

Statistically I think the risk has increased, but I think we're still firmly in the unlikely column even though we saw equity markets dip a little the day after the Fed meeting.

Remember, depending on how you measure, we're only at the halfway point in spending the \$787 billion in stimulus funds.

And a lot of money that's been allocated has yet to actually get into the economy.

Right. Consumer spending is up a little from its lows. Business spending is up. And the auto industry is a relative success story. Increased profitability albeit on reduced sales, but the corner has been turned in the business sector. And a similar story in banking and finance industries.

And manufacturing jobs have bounced back. More than 130,000 new jobs in that sector.

Overall, Brett the White House estimates that between 2.2 and 2.8 million jobs have been funded so far this year.

And by year end 3.5 million jobs created or – and this last part is important – retained as a result of Recovery Act spending. And a lot of the next phase in spending is in infrastructure – everything from improved highways to increasing access to broadband. Projects that will directly create jobs and hopefully spur longer-term economic development.

But on the risk side of the ledger . . .

Despite improvements, consumer spending and unemployment of course. Bank lending continues to be below where it should be. And we've got a great deal of belt tightening at the state level that's partially offsetting stimulus at the federal level. But a recovery from depths of recession we haven't experienced since the 1930s is never going to be smooth. Remember it was only about 18 months ago that the economy was contracting at an annualized rate of more than 6%.

Today, we're on the right track and by and large the right steps are being taken. I still think we'll see moderate growth in economic activity and an improvement in the unemployment numbers around year end.

Thanks Brett. This has been the August edition of Investment Insights. Thank you for listening.

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