

2010 – Which Way is up?

Hi, I'm Brett Hammond, Chief Investment Strategist at TIAA-CREF.

Even with the recent market downturns we saw in late January, 2010 begins with a far more optimistic outlook than 2009 did. Then, the US and countries around the world were locked in the grip of a global "Great Recession." Markets were falling rapidly, housing prices and sales were plummeting, bank failures were rising, jobs disappearing, and consumers, quite understandably, quit spending.

Many of these declines were more severe than at any time since the Great Depression at the beginning of the 1930s.

Today though, things are looking up. After hitting bottom in early 2009, global equity and credit markets staged furious rallies, posting some of the strongest gains in decades. Volatility in many markets declined from all-time highs and consumer confidence has started to tick up.

The Treasury yield curve is steeper today. This means that yields -- or coupon rates -- on longer term government debt is higher than shorter term government bonds, which suggests that investors anticipate future economic growth.

Housing prices and job losses may thankfully be in the process of stabilizing. Retail sales have increased, and manufacturing is growing again, as are the economies of many countries around the world.

A FRAGILE ECONOMIC RECOVERY

Despite some good news, the economic recovery here in the US is fragile. Many of the positive upward trends are moving in fits and starts, good one month and less so the next. Consumption spending, which makes up over 65% of the U.S. economy, will have a hard time achieving recovery-like growth while unemployment remains high.

Individual incomes for the vast majority of Americans will continue to decline as they have been doing since the beginning of the last decade. Government stimulus through increased spending, low interest rates, and purchases of fixed-income securities, provided a basis for improved conditions in the latter half of 2009 and will continue to do so into 2010, but support for significant additional public fiscal and monetary stimulus is wobbly at best.

During the Great Recession of 2007-2009, the US economy will have shrunk by more than 4%. The good news is, technically at least, the recession is behind us. In the third quarter of 2009, the U.S. economy rose about 2.2% on an annualized basis. We expect growth in the fourth quarter to be north of 4%, declining to a little less than 3% for the first quarter of 2010 and about 2.5% for 2010 overall.

Unemployment will improve, but probably not markedly until late in the year.

A number of factors affect the prospects for a tentative recovery as the year progresses. We'll see short-term interest rates rising later in the year and the conditions for robust equity growth, will taper off. Corporate earnings growth has been relatively good of late, but the reduced capital and compensation costs that drove recent earnings improvements can't do so forever.

And even though it's something that still tends to get a lot of exposure in the media, inflation will remain benign for quite some time. Increased federal debt and rising short-term interest rates being offset by, among other things, the limited wage pressure that comes with high unemployment.

A RAPID TURNAROUND, BUT CONTINUED VOLATILITY

The performance of financial markets in 2009 was, to say the least, remarkable. After hitting bottom in early March, broad U.S. equity indexes experienced their best three-quarter performance since the Great Depression. The S&P 500 and the Russell 3000 were both up over 26% for the year. But the big story in equities was overseas. Excluding Japan, Asia and emerging market stock indexes rose between 70% and 80% in 2009. And developed country equity markets, led by Europe, outpaced U.S. equities, returning over 30%.

Fixed income markets also showed gains, though the news was more mixed than in the equity markets. The Barclays U.S. Aggregate Bond Index, which includes U.S. Treasuries as well as a wide variety of corporate bonds, returned about 6% for the year. Of that, corporate bonds, particularly high-yield bonds, were the big performers. In contrast, after returning over 12% in 2008, the Barclays U.S. Government Bond Index fell over 2% as investors' appetite for corporate debt returned.

REITS, which are stocks of companies that invest in real estate, rose over 30% during the third quarter and nearly 28% for the full year in 2009 after falling nearly 40% in 2008. Direct real estate investment ownership of office, retail, industrial, and multifamily rental buildings is still going through its first significant downturn since the late 1980s and early 1990s. But I think building values may now be in the process of bottoming out.

2010 OUTLOOK: WHAT TO LOOK FOR

Stock prices tend to anticipate future economic and profit growth as well as other economic news. The question now facing investors is whether corporate earnings and the economy will rise enough to justify the market gains that we've already seen.

Among the less positive signs, news from the housing sector remains mixed at best. Construction spending is still falling. Troubled mortgage assistance has occurred, but not on a large enough scale. Regional banks are still continuing to fail. And even the recent

rise in manufacturing won't help significantly unless consumers buy what's being produced. The rise in household savings we've seen -- from zero to about 5% of income -- will be good for long-term economic health as it increases sources of domestic investment. But in the short run, a savings increase means an equal drop in consumption - the largest component of the economy.

As I said earlier, we expect the U.S. economy to grow at about 2.5% in 2010 and Global economies at about 4%.

But in the near future at least, growth is dependent on public policy. Monetary stimulus such as low interest rates and government securities purchases is still strong. And Fiscal stimulus such as spending and tax cuts has now kicked in and will continue for another year or so.

Eventually though, loans must be repaid, distressed securities resold, interest rates raised, and deficit spending reduced. Too soon or too little and we risk a return to recession. For example, in the New Year, look for a necessary and visible debate on the need for additional government stimulus.

Too late or too much and there is danger of inflation. And the era of extreme asset bubbles may not be over. A large pool of global capital available for investments, a definite lack of consensus on expected returns for various asset classes, and an uncertain regulatory landscape, all create conditions where bubbles might occur.

Rising incomes that tend to come with economic expansion could fuel consumption and investment, which can, in turn, benefit corporate profits and economic growth. But the more likely scenario is a continuing decline in incomes which will, instead, act as a drag on consumption and the economy overall.

LOOKING PAST "THE GREAT RECESSION"

Even though we're on the road to economic recovery, given the uncertain outlook, and without additional government stimulus, current conditions and trends will limit recently high-performing asset classes beginning in the first half of 2010.

What might cause this picture to turn out differently? Unfortunately, the fragility of economic and market recoveries is real. Poor economic news, stagnant sales, a meltdown in Asia, inappropriate economic policy actions could all challenge the recovery.

So the "Great Recession" is technically over, and almost all markets are well off their lows. Nevertheless, we're seeing ongoing volatility, heightened uncertainty about future recovery and widely disparate returns across asset classes.

For individual investors today, an asset allocation that's appropriate for your time horizon and risk tolerance is just as important as it ever was. In light of the prospects for volatility and asset bubbles, don't forget to rebalance if you haven't done so recently.

2008 was one of the worst years for the markets in some time. But 2009 was in many cases, among the best. Because things can change so quickly, it's important to stay the course and take a long term outlook to investing.

Last and certainly not least, recent events highlight the need to make sure you have enough income throughout your retirement. Find out what role guaranteed income can play in your portfolio. A trusted and independent advisor can provide valuable guidance and help you find the right direction.

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