

Market Monitor

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As You Save, So Shall You Reap

U.S. households love to spend money. They spend it on all kinds of things, including large and numerous cars, more-than-ample homes, fancy food and far-from-basic vacations. In fact, spending and shopping have become major recreations unto themselves. There is a flip side, however, to all this spending – the huge lack of savings in American society. This week we will focus on the following:

- Dimensions of this lack of savings
- Reasons why the dearth of savings may pose some risks for the economy
- Impact of the lack of retirement savings on the performance of the U.S. economy and the financial markets in coming years

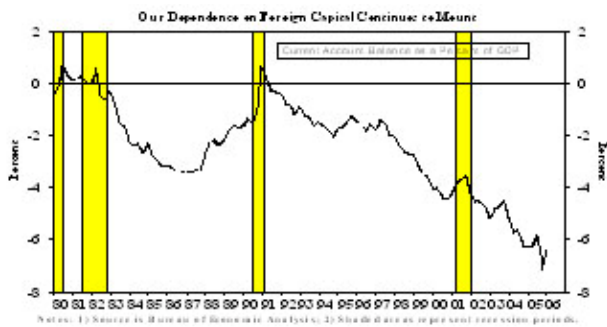
U.S. households have been saving less of their after-tax incomes for over 25 years. That proportion, the ratio of personal savings to after-tax personal income (called the personal savings rate), has fallen from roughly 10% in 1980 to -1.5% today (see chart).



This is a big swing resulting in households “dissaving,” or spending more than what they receive after taxes in wage and interest income. As a result, according to the Federal Reserve’s Survey of Consumer Finances (SCF), median family net worth rose about \$22,000 over the 10 years ended 2004 to \$93,000, with the bulk of the gain coming from high income families and reflecting buoyant housing values over that period.

Why has this happened? First, household balance sheets have improved, resulting from a run-up in home prices and from the booming stock market of the late 1990s. As a result, consumers ramped up spending, in many cases taking on more debt to finance that spending. Second, the economy has become less volatile over the past two decades, in part due to better macroeconomic management by policymakers (especially the Fed), causing consumers to question the need to save for a rainy day, the arrival of which appeared less likely. Finally, the savings rate’s deterioration may have been abetted by economic policy. The Fed kept interest rates low for a long time, inducing households to spend rather than save. And, continually lowering tax rates over the past two or so decades probably also had a similar effect, placing more after-tax income in the hands of households who then were able to service greater amounts of debt in support of increased spending. Indeed, the government itself continued to participate in the dissavings party, running sizable budget deficits to fuel consumer-led economic growth.

Not surprisingly, this lack of saving has a dark side, particularly over the longer run. At a macroeconomic level, the lack of savings here at home has meant that we have become increasingly dependent on foreign capital to finance our capital investments. We have become the world’s largest borrower, currently to the tune of 6.5% of GDP, up dramatically from 2% just 10 years ago (see chart). This high rate of borrowing from abroad is clearly unsustainable over the longer term, since it implies huge, unbearable amounts of future debt service for the country. Also, our large dependence on foreign capital makes the economy more vulnerable to any diminution of those flows or a change in terms at which lending is available. As the experiences of other countries in similar situations have shown (e.g. certain Latin American countries), a sharp diminution of such flows may lead to sharp



economic reversal, even recession.

The dark side of dissaving will likely also be felt at a more personal level over the longer term. Those “living large” today, saving little, even dissaving, may find that they are living much smaller tomorrow. This is true for retirees, especially those of the “baby boom” generation. For instance, the Fed’s most recent SCF showed that families headed by 45-54 olds had a median net worth of just \$145,000 in 2004 (including the net worth of their home and any defined contribution monies they might have) – far from being a large retirement nest egg. It is obvious that the median “baby boomer” has little outside of their corporate (defined benefit) pension and Social Security to live on during retirement. With continued cutbacks in corporate defined benefit pensions, “baby boomers” may see another source of retirement income diminish or disappear. For many “boomers” their old-age income plan may be continued work.

And of course, the financial markets will not be immune to such developments. As increasing numbers of “baby boomers” retire, or at least attempt to retire, the amount of money going into savings vehicles may decline. Investment returns may be less than they have been in the recent past. Changing

demographics may also adversely affect investment returns. Retirees, with diminished incomes, generally spend less overall, devoting less of their income during retirement to discretionary items (such as fancy clothes) and larger portions to non-discretionary areas such as healthcare. This means that the economy overall may grow more slowly and that discretionary areas of spending may slow, perhaps even decline. Consequently, this scenario sets the stage for lower overall investment returns and, perhaps, dramatic shifts in sectors currently showing good returns.

However, this saga doesn’t stop there. With the “baby boomers” retiring, Social Security and, especially, Medicare will likely face tremendous financial burdens. Due to a lack of reform and chronic budget deficits, we are now in a situation where almost anything the government does to mitigate those burdens will cause investment returns to decline. If they raise payroll taxes or cut Social Security and Medicare benefits, economic growth and financial market returns will likely suffer. And if they increase borrowing to finance program shortfalls, real interest rates may rise, hurting the economy and returns on financial instruments (assuming, of course, all else is equal).

In summary, we examined the lack of savings of U.S. households, the reasons that this scenario may pose risks for the U.S. economy and how this will likely adversely affect the performance of the financial markets and the U.S. economy in the future. The primary reason for this dimmer view resides not with what we might do in the future, but what we have failed to do as a society in the past. Hence, as you save, so shall you reap.

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Brett Hammond, Leo Kamp and Douglas Fore are available to comment on economic data. If you wish to speak with them, please contact Stephanie Cohen Glass, Media Relations, 212-916-4993 or email scohenglass@tiaa-cref.org.

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