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BRETT HAMMOND
CHIEF INVESTMENT
STRATEGIST

LEO KAMP
CHIEF ECONOMIST

DOUGLAS FORE
DIRECTOR OF PORTFOLIO
ANALYTICS

Will Oil Prices Float Higher in Cooler Economic Waters?

As we all know, oil and natural gas prices have soared over the past three years. Light crude oil prices are now around \$60, about twice what they were in late 2002, but less than they were earlier this year.

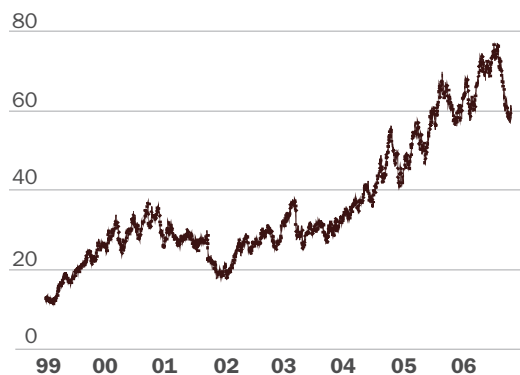
At the gasoline pump, drivers who used to pay about \$1.50 for regular gas were paying more than \$3. While regular-grade gasoline has more recently dropped below \$2.25 in most places, the question remains whether or not this is simply a transitory respite from a secular climb in energy prices. Our themes for this week are as follows:

- Naturally, world energy supply and demand patterns are the keys to understanding where oil and other energy prices are headed
- In the absence of a politically induced energy supply shock, modest economic growth over the next year or so and limited energy supply increases will keep prices from skyrocketing
- In the long run, higher energy prices may produce supply and demand innovations that may sow the seeds for future price stability

As explanations for soaring energy prices, supply and demand may sound like economist clichés, but in this case the economists are right. In the late 1990s, gasoline prices, for example, had actually dropped in inflation-adjusted terms to a 25-year low. As inflation-adjusted prices came down in the 1990s, it was no surprise that in America gas-guzzling SUVs were all the rage and developing countries could afford to ramp up their own energy consumption.



SPOT PRICE FOR LIGHT CRUDE OIL, \$/BARREL



Source: Datastream

But then energy prices rose rapidly beginning in mid 2003. Developed economies around the globe were emerging from the very subdued economic conditions that had prevailed in the first couple of years of the decade. This, coupled with ongoing buoyant conditions in China and other emerging economies, caused global energy demand to soar. At the same time, energy supplies had tightened, the result of years of underinvestment in exploration and refineries. Why invest in a sector where inflation-adjusted prices were falling when more appealing opportunities were available in such places as information technology and health care? So, with more limited supply facing burgeoning demand, it's no stretch to see why energy prices rose so dramatically.

It's also worth noting that other commodities saw a similar pattern of dramatic price increases over the same period (copper prices rose from about 70 cents per pound to about \$4 earlier this year), reflective again of limited supply facing much stronger demand. Because of the lack of slack in commodities, any actual or potential supply disruptions were reflected immediately in higher prices. Recall the price increase wrought by the start of the Iraqi war and by Hurricane Katrina.

So, will we see this constellation of tight supply and burgeoning demand reemerge going forward, causing oil prices to soar again? Well, the answer is not surprising: **it all depends** on what happens with energy supplies and the demand for those supplies going forward.

On the supply side, over the next two years we anticipate only limited new oil production will come on stream. Investment in the Caspian Sea area, Equatorial West Africa, Brazil, the deep-waters in the Gulf of Mexico, the South China Sea, oil sands in Canada, and Saudi Arabia will all be paying off over the next two years, resulting in modest supply additions to world energy markets. But don't expect this new capacity to solve the problem. Global oil supplies will still likely remain relatively tight.

On the demand side, as we've pointed out elsewhere (10/23 and 10/30 Market Monitor), we expect global economic waters to get cooler, the result of rising short-term global interest rates over the last two to three years. With moderating global economic growth, expect slower growth in the demand for energy and other commodities.

The question then becomes whether a modest supply increase and a global demand slowdown will together prevent energy prices from surging again in the near term. Most likely energy and other commodity prices will continue to rise, but at a pace far less dramatic than what we saw over the past three or so years. Only if the global economy falls into recession again would we expect to see energy prices decline over the near term. But, over the longer run, perhaps over the next 5-10 years, we may again see sustained inflation-adjusted moderation in energy prices. High, rising energy prices eventually induce more energy supplies to come to market, some in conventional form (traditional fossil fuels, but perhaps from unconventional sources), others in radically different forms (e.g. cogeneration, solar, wind, tidal power) that were not economic when energy prices were lower.

In addition, and very importantly, high, rising prices induce less demand. Like other things, when energy is cheap, conservation is on the back burner. On the other hand, behavior can change dramatically when energy becomes dear. Then, minimizing energy usage moves to the front burner. With high prices, people are induced to save energy in a variety of ways, including returning to fuel-efficient vehicles, building and utilizing more energy-efficient mass transit, buying lower-energy appliances, and reducing the use of energy in industrial processes. This can happen, as it did in the 1980s, when in the face of high energy prices, countries around the world dramatically reduced the amount of energy it takes to produce a dollar of GDP. So, the longer energy prices remain high or rise, the more interest we'll all have in finding ways to reduce the impact of those prices on individual and national pocketbooks through solutions grounded in supply and demand. In short, high, rising prices can sow the seeds for eventual price stability or decline.

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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 Chad Peterson, Media Relations, 212-916-4808 or email cpeterson@tiaa-cref.org.

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