

Quarterly Market Monitor

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Q3 2006 Developments:

- U.S. growth continued on a slower track in Q3 from earlier in the year.
- Core inflation picked up in Q2, but moderated in Q3 as expected, with energy prices still not feeding through to other prices to any large degree.
- Housing's retreat is keeping consumer spending slow and inflation well-contained.
- Economies in Europe and Japan were generally slower in Q3 versus earlier in the year, but China remained robust.
- With inflation in check and the Fed on hold, U.S. asset markets started rallying in Q3.
- The global appetite for risky assets improved in Q3, resulting in both bonds and equities rallying during the quarter.

Remainder of 2006 and First Half 2007

Expectations:

- U.S. growth is to remain slow during the remainder of 2006 and slow a bit further early next year.
- The U.S. housing market decline and consumer slowdown probably will not lead to recession.
- The Fed will likely remain on hold over the rest of 2006 and well into 2007, but the European Central Bank (ECB) will likely continue hiking interest rates.
- Slower growth prospects seem likely in Europe (including the UK) and in Japan.
- China may slow in 2007, but still show growth far above developed economies.
- Global asset markets remain vulnerable to the resolution of large global imbalances and to adverse shocks, especially given heightened geopolitical uncertainty.

- With the global economy slowing, corporate profits could decelerate, resulting perhaps in lower equity returns and rising credit concerns on corporate bonds.

Third Quarter Developments

After flashing some warning signals earlier, markets became more sanguine about risk in Q3. The implied volatility of asset prices has declined sharply (by about one half) since soaring in late spring. This means that investors now perceive the riskiness of their securities and portfolios as being much less than in the middle of the year. As a result, equity markets around the globe have rebounded. In the U.S., broad equity markets showed gains of about 5-6% quarter-on-quarter last quarter versus the negative returns posted during the earlier period when risk perceptions were much higher. European and emerging markets saw similar rebounds during the quarter.

United States

From a blistering pace earlier in the year, the U.S. economy started to slow in Q2. In Q3, it became evident that this slower growth track would be with us for quite a while. Q3 real (inflation-adjusted) Gross Domestic Product (GDP) growth likely grew below the 2.6% annualized pace of Q2. This slower result was due to still-subdued consumer spending combined with increased drags from housing and foreign trade.

The weaker pace of consumer spending is fundamentally based and is likely to continue. Gains in household financial wealth have slowed with the evaporation of the sizable home price gains we saw nationally in the past. In August, we actually saw the median price of existing single family homes decline on a year-on-year basis for the first time in 10 years. Labor income remains slow because of less hiring and smaller wage increases. And, the Fed has more than quintupled short-term interest rates over the past two plus years making consumer borrowing more expensive. So it is no surprise that consumer spending and the economy are now slower and are likely to remain so for a while.

But there are dividends from the slower economic trajectory now in place: inflation appears to have moderated and the Fed seems to be on hold. After a worrisome increase in Q2, "core" inflation (i.e.,

inflation excluding food and energy price movements) moderated in Q3. After running at a high, almost 4% annual rate in the prior quarter, “core” Consumer Price Index (CPI) inflation ran around 2.5% in Q3. As a result, the Fed, after hiking its Federal Funds rate 17 straight times to 5.25%, chose at their August and September meetings not to tighten further. However, at both of those meetings, they did indicate a willingness to tighten again should inflation and growth pick up beyond their “comfort zone.” Incoming data and our expectations of the Fed remaining on hold (but not easing) suggest that both “core” inflation and economic growth are now on a sustained slower path.

The Treasury bond market has bought into this view, with the yield on the 10-year Treasury note falling over much of Q3, to now well below 5%. Bond market participants have become much more sanguine about inflation and apparently now believe, as we do, that the Fed has likely finished tightening. And, given the relatively small inversion of the Treasury yield curve, these same bond market participants still seem to place only a low probability of recession occurring down the road.

Indeed, most investors became more sanguine about financial markets in general, with implied risk levels on securities falling sharply during the summer following a large run-up in the spring. In addition to the rally in bonds, broad-based equity markets in the U.S. and elsewhere rose 5-6% in Q3 versus anemic gains in the first half. So the appetite for risky assets increased markedly during the quarter.

Europe

The Euro area as a whole seemed to have slowed a bit in mid-Q3, with the manufacturing and service purchasing managers indices showing declines in August and down and flat results in September, signs of softening not evident earlier in the year. Even Germany, which had generally been doing better than others in the Euro zone, showed some signs of slowing in August and September. While only for two months, these data may presage a more sustained slowdown over the rest of the year. With short-term interest rates higher and the U.S. now clearly on a sub-trend growth path, some slowing in Euro area activity seems likely. But despite this, the European Central Bank (ECB) continued to raise

interest rates in early August, by 25 basis points to 3%. It did this since their two guide posts — CPI inflation and money growth — still remained above target. During Q3, CPI inflation has been running near 2.5% year-on-year, above their 2% target, and money growth has registered about 8% year-on-year, far above their 4.5% reference value. So look for further ECB tightening in coming months (they raised rates again in early October), even with the Euro-land now looking like it’s on a slower growth track.

Asia

Japan’s recovery now seems to have moderated a bit, at least in terms of the pace of the economy growing. Investment by businesses and consumer spending, both earlier thought to propel growth higher this year, now seem to be on a slower path than originally expected. As a result, we saw a surprising growth slowdown in Q2, with real GDP growth coming in at just 1% annualized, after a vibrant 3+% gain in Q1. And, we likely will see only a modest rebound in Q3, with real GDP growth perhaps at 2% annualized during the quarter. But despite growth falling somewhat short of earlier expectations, Japan has clearly emerged from its almost decade-long bout with deflation. National CPI inflation has been in positive territory for months and has been gradually ticking up over the past few months, even after downward revisions to the data recently. As a consequence of the economy recovering and deflation conquered, the Bank of Japan (BoJ), as expected, exited its long-standing zero interest rate policy in July, raising its targeted rate beyond zero (to 25 basis points) for the first time in years. The BoJ may hike rates once more this year, but if the economy continues to look softer, chances are that further tightening will be deferred until next year.

In the rest of Asia, China continues to be the growth star, with Q3 readings suggesting that growth during that quarter will still be quite impressive, although a bit below the stunning 11.3% year-on-year gain of real GDP in Q2. But growth there is still very lopsided, with much of the economic gains still derived from soaring (in many cases speculative) public and private investment. The central authorities there have recognized this, putting in place measures to slow the pace of investment. Besides raising interest rates and reserve

requirements (both modestly) to curtail bank loan growth, they have issued new land-use and investment regulations in an attempt to minimize excessive investment. Only time will tell whether they were successful this time in permanently reining in investment. Past efforts along those lines have only resulted in transitory slowdowns in investment activity.

2006 Global Economic and Market Outlook

- As mentioned previously, we expect the U.S. to be on a slower growth track over the remainder of this year and well into 2007. This slower expected trajectory is largely the result of housing activity declining over that period. The decline in housing will also be a major driver behind declining car sales, lackluster overall consumption growth and slower employment. Recession, however, seems unlikely at this point. But, one result of the slowdown is that oil and other commodity prices will decline a bit or at least stop rising, which combined with less tight labor markets, will help to lower overall inflation. With that as a backdrop (less growth, less inflation), the Fed will probably remain on hold well into 2007. In such an environment, we also expect the trade-weighted dollar exchange rate to weaken on average over the remainder of this year and into 2007, as the Fed remains on hold and other central banks continue to raise rates.
- Recent evidence tentatively suggests that growth in Euro-land and the UK (to a lesser extent) may be slipping in coming months.
- Japanese economic growth this year appears to be somewhat front-loaded with the quarters following the first showing significantly lower growth rates. As a result, growth this year will probably come in close to 2.5% versus the earlier consensus expectation of 3%.
- Chinese growth will continue to be impressive, even though excessively derived from investment. It remains to be seen whether the numerous measures put in place by Chinese authorities to rein in investment will be successful.
- And finally, we continue to be concerned about how large global imbalances will be successfully resolved. More specifically, we remain uneasy about how asset markets may react as such imbalances are resolved, particularly if the adjustment process is not smooth. In addition, we remain cautious about the vulnerability of the global economy and asset markets to adverse shocks, especially in an environment of slowing growth and heightened geopolitical risk and uncertainty.
- While most asset markets posted better returns in Q3, the world is still full of risks and uncertainties that could cause that performance to reverse sharply. Indeed, even absent such risks, as the global economy slows, corporate profits are poised for deceleration in coming months. This in turn could lead less-than-vibrant equity returns and heightened credit concerns about corporate bonds.

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