TIAA-CREF asset management®

QUARTERLY MARKET MONITOR
FIRST QUARTER 2007
ECONOMIC REVIEW

BRETT HAMMOND
CHIEF INVESTMENT STRATEGIST

LEO KAMP
CHIEF ECONOMIST

DOUGLAS FORE
DIRECTOR OF PORTFOLIO ANALYTICS

Q1 2007 DEVELOPMENTS:

- Once again, our long-standing below-consensus growth forecast tracked well in Q1. U.S. economic growth probably slowed further during the quarter from late last year, continuing to reflect the ongoing sluggishness that emerged earlier.
- This slowdown is due to less vigorous consumer spending, a continued drag from housing and net exports, and a slower pace in business capital spending.
- Weaker hiring also contributed to the slowdown.
- Inflation increased during the quarter, due to a rebound in energy and other commodity prices.
- Despite the pickup in inflation, the Federal Reserve (Fed) left its interest rate target unchanged at 5.25% in an apparent acknowledgement to the slow growth, and introduced more flexibility into its policy stance, indicating that easing, not just tightening, were possible in the future.
- Economic growth conditions elsewhere around the globe continued to do well, with the exception of Japan's economic growth, which seemed significantly lower than last quarter.
- After an apparent repricing of risk in late February/early March that caused a rout in equity markets around the globe, equity markets and risky fixed income products regained most of the ground lost over the remainder of the quarter.
- In line with our forecast, the dollar continued to weaken versus European currencies during the quarter.

TIAA CREF

FINANCIAL SERVICES
FOR THE GREATER GOOD®

REMAINDER OF 2007 EXPECTATIONS:

- U.S. growth is expected to remain on the slower growth trajectory throughout the remainder of the year, with soft housing activity continuing to drag on growth.
- The unemployment rate may increase, rising to 5% by year-end, due to continued sluggish growth.
- Inflation will probably drift lower as commodity prices cease rising and labor markets become less tight.
- The trade-weighted dollar will probably continue to weaken in 2007, as interest rate differentials narrow between the U.S. and rest of the world and as China's currency gradually appreciates vs. the dollar.
- The Treasury yield curve will likely remain inverted during 2007, but less so in the second half if the Fed eases.
- Euroland (including U.K.) growth could soften some in the second half, due to slower growth abroad.
- Economic growth in Japan will likely remain fairly stable, with investment and exports as the principal growth drivers.
- China's economy will likely remain strong, but export growth may be less robust as the year progresses, as much of the developed world sees slower economic growth.

FIRST QUARTER DEVELOPMENTS

UNITED STATES

Our forecast for sub-consensus growth tracked well during the first quarter, although the consensus is finally increasingly gravitating towards that forecast. During the quarter, U.S. economic growth (measured in inflation-adjusted GDP terms) slowed some from late last year, with growth (at annual rates) about a percentage point lower than the 2.5% registered for the final quarter of 2006.

This slowdown arose from less vigorous consumer spending, a continued drag from net exports, and a slower pace in business capital spending. Some of the slowdown resulted from the absence in first quarter 2007 of the statistical boost the previous quarter's consumer spending received from the unseasonably warm weather during much of that quarter. Likewise, the somewhat weaker hiring and the declines in housing demand and production we saw during Q1 probably resulted from a similar phenomenon. So, net-net, Q1's growth continued to reflect the ongoing sluggishness that emerged early last year.

But despite a more sluggish U.S. economy, energy prices and other commodity prices rebounded in the first quarter. Oil prices rose from the mid-$50 range into the low-$60 range. Copper prices, which had fallen to $2.40/lb. late last year, rebounded by about $1/lb. into the mid-$3/lb. area. As a result, we saw a pickup in inflation during the quarter, with overall CPI inflation rising at a 4.7% annual rate during the quarter versus the low 0.2 rate seen in the prior quarter. Similarly, "core" CPI prices (those outside food and energy) rose more robustly last quarter, at an annual rate of 2.3%, compared to the 1.6% we witnessed during the final quarter of 2006. Even with this rise in CPI inflation, the Federal Reserve left its interest rate target unchanged at 5.25% throughout the quarter, and, in an apparent acknowledgment to the slow growth during the quarter, introduced a bit more flexibility into its policy stance, indicating that easing, not just tightening, were possible depending on circumstances. Generally, the Fed seemed fairly pleased with the economy's recent performance—with the economy slower but not in recession and inflation, although higher recently, still looking well contained.

EUROPE AND ASIA

Economic growth conditions elsewhere around the globe continued to do well.

During the last quarter, the Euro area continued to display solid growth, similar to what prevailed during much of 2006. Moreover, as seen previously, these growth results were a bit uneven across the "Big Three" Euro area countries—Germany, France and Italy. Again, Germany seemed to lead the other "Big Three" countries in terms of growth. However, inflation in the Euro area edged higher during the quarter, fueled by global energy price increases, with headline CPI inflation reaching 1.9% year-on-year (Y/Y) in March, just a tad below the European Central Bank's (ECB's) target of 2%. In addition, money growth has risen in Euroland, with broad money growth reaching almost 10% year-over-year, more than twice the ECB's 4.5% target. Given the ECB's monetarist bent, such rapid money growth is enough alone to keep the ECB in tightening mode for quite some time, well beyond the last hike 25 basis point hike in interest rates in March.

Counter to consensus (but not our) expectations earlier this year, interest rates will likely continue to rise in the U.K., the result of still-solid economic growth there, buoyant home prices (now rising almost 10% Y/Y), continued double-digit household debt growth, and inflation (at 3.1% Y/Y in March) now more than a full percentage point above the Bank of England's 2% target.

Meanwhile, economic growth seemed to be significantly lower in Japan last quarter compared to 5.5% annual rate registered for Q4 last year. Both business investment and exports appeared to have softened some, while household spending again appeared to turn unimpressive results. With the economy softer in Q1, inflation continued to decline, with year-on-year CPI inflation actually dipping into negative territory again in February. But despite a reappearance of more subdued growth and prices barely increasing, perhaps even decreasing, the Bank of Japan (BoJ) raised interest rates once by 25 basis points during the quarter, taking its repo rate target up to a still very low 0.5%. The BoJ seems inclined to continue raising rates gradually this year, but only will do so if it can find adequate "cover" (for example, stronger growth or higher inflation) to do so.

And again, China's rapid growth continued unabated during the quarter, probably again coming in over 11% Y/Y for the quarter. The main drivers that propelled last year's over 10% growth remain in place. Investment activity and export growth still appear strong. Moreover, the monetary policy and administrative measures taken by the government to rein in overly rapid investment still seem to have had little effect. In addition, inflation rose some during the first quarter, due mainly to the higher world energy and grain prices. Given still-too-rapid investment and somewhat higher inflation, it's reasonable to expect further government measures (interest rate hikes, administrative controls) to slow the economy to a more sustainable, reasonable pace this year.

After an apparent repricing of risk in late February/early March that caused a rout in equity markets around the globe, equity markets and risky fixed income products regained most of the ground lost over the remainder of the quarter. That retracing of lost ground is a bit surprising given that the catalysts for the earlier rout have not dissipated, namely: slower-than-expected economies and earnings around the world, rich equity prices and even speculative froth in some markets (for example, China's markets), continued global monetary tightening, and the narrowness of the rebound in some markets.

2007 GLOBAL ECONOMIC AND MARKET OUTLOOK

EXPECT U.S. GROWTH TO REMAIN SLOW

The slower growth trajectory that emerged in the U.S. during 2006 will likely continue for the remainder of the year.

- Economic growth will continue at slow rate in the second quarter, with soft housing activity continuing to exert direct and indirect drags on growth.
- Oil prices and other commodity prices will likely see only modest declines from current levels as we progress through the remainder of 2007.
- With growth remaining slow, the unemployment rate will pickup, rising to 5% by year-end, up from the 4.5% rate seen in March.
- Inflation will continue to drift lower as commodity prices cease rising and labor markets become less tight.
- But despite a slow economy and inflation drifting lower, the Fed will likely remain on hold over the rest of the year, maintaining its Fed funds rate at 5.25%. Only if the economy becomes softer than expected, will the Fed ease, and only then to a limited extent. They would only ease aggressively if a recession were to take hold.
- The Treasury yield curve will remain inverted during 2007, but less so in the second half if the Fed eases.

SOURCE: TIAA-CREF ASSET MANAGEMENT

- The trade-weighted dollar will probably continue to weaken in 2007, as interest rate differentials narrow between the U.S. and rest of the world and as China's currency gradually appreciates versus the dollar.

EURO AREA GROWTH LOOKS TO SOFTEN LATER THIS YEAR

Recent evidence suggests a continuation of solid, but somewhat softer, growth in the Euro area this year. Some of the major themes surrounding this view are:

- Euroland growth will remain solid, again supported by exports and investment, especially in Germany. Consumer spending will likely remain relatively subdued.
- Growth could soften some in the second half of the year, due to a slower growth abroad, higher interest rates, and Euro appreciation cutting into export growth and investment activity.
- Employment growth should slow with a softer Euroland economy later in the year, limiting further improvement in the unemployment rate.
- A softer economy probably means inflation will eventually become less worrisome to the ECB later this year, causing them to stop raising rates, but only after raising rates a couple of times in the first half of the year.
- The Euro will again see some additional appreciation, ultimately reaching at least $1.40 this year.

U.K. ECONOMIC GROWTH WILL ALSO LIKELY SLOW

Similar to the Euro area, growth in the U.K. will probably also soften some later in 2007. Some of the reasons for this view are:

- With inflation now way above target, The Bank of England will likely turn more aggressive in reining in inflation. This means that interest rates will probably continue to move higher in coming months, with at least two more 25 basis point increases expected from the Bank of England, perhaps more if the economy and inflation do not moderate.
- Higher interest rates will eventually cause the housing market to soften, resulting in much lower home price inflation.
- Less home price inflation means that home equity will grow less rapidly, which in turn could cut into consumer spending growth.
- And with the U.S. slower and the British pound rising during much of the year, we should also see net exports detracting somewhat from growth this year.

STABLE GROWTH PROSPECTS CONTINUE IN JAPAN

Economic growth in Japan this year will likely remain fairly stable and, on average, near 2%—only a bit less than we saw in 2006. The major reasons for this are:

- The composition of growth in Japan will likely remain fairly stable this year, with investment and exports as the principal growth drivers.
- However, Japan's growth this year, dependent as it is on exports, will edge down some as the rest of the world (particularly the U.S.) slows.
- Moreover, last year's experience suggests that consumer spending will likely disappoint as a growth driver, despite improved hiring and larger bonuses.
- With growth far from robust, inflation will likely remain quite subdued, especially in the presence of very low money growth.
- With inflation very low and the economy softer, the BoJ will take its time in "normalizing" (that is, hiking) short-term interest rates, and, as previously mentioned, only if it has adequate cover for doing so.
- With little movement in interest rates and the economy slower this year, it is unlikely that we will see a massive appreciation of the yen versus the dollar, although some appreciation will still likely occur.

SOURCE: TIAA-CREF ASSET MANAGEMENT

CHINA'S ECONOMY WILL REMAIN STRONG, BUT SOME SLOWING WILL BECOME EVIDENT AS WE PROGRESS THROUGH 2007

The major themes surrounding this view are:

- China's export growth will likely be a bit less robust as much of the developed world sees slower economic growth, first in the U.S. and Japan, later in Europe.
- In addition, we will likely see more moves from a government that now appears to be more determined in reining in China's rampant investment. The People's Bank of China (PBoC) now appears more aggressive than it was in 2006, raising interest rates and bank reserve requirements more aggressively than it did last year. These moves, together with those already in place, will likely result in some diminution of real GDP growth as we progress through the year.
- Moreover, China's program to resurrect a social safety net will take time to implement. Furthermore, it will take time for people to regain confidence in the government's programs. Meanwhile, consumers will probably not decrease their rate of precautionary savings much, thereby undermining the government's goal of shifting towards a more consumer-driven economy.
- And finally, continue to look for only modest, token appreciation of the China's currency, by a maximum of 5% versus the U.S. dollar this year.

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.

C38595