

WEEKLY MARKET MONITOR

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A NEW YIELD CURVE

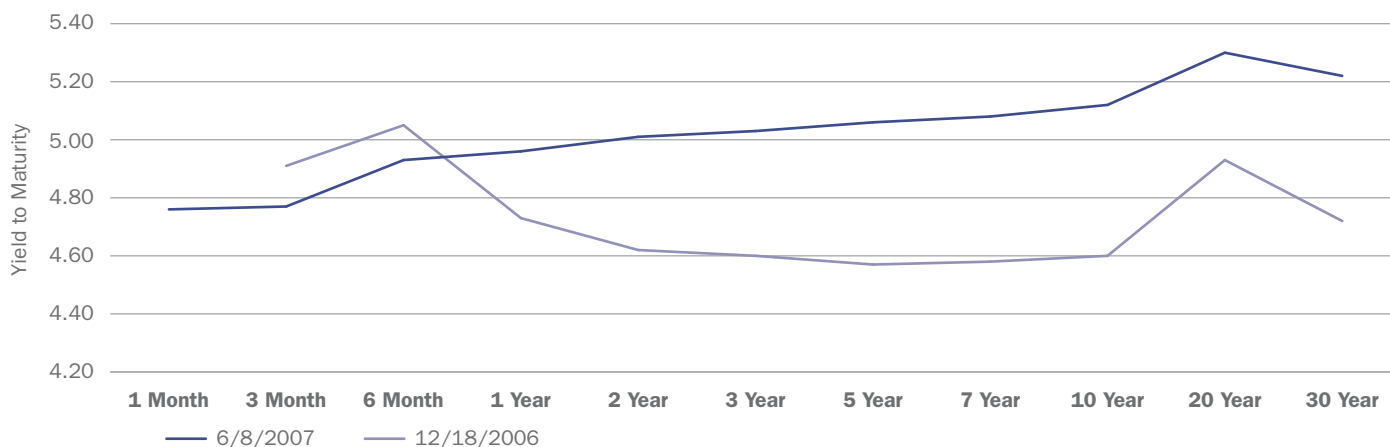
Last week, for the first time in many months, the U.S. Treasury yield curve began to look a little more like its usual self. For the most part, it now slopes upward instead of downward, as it had done since 2006. This means that higher yields are now generally associated with longer-dated U.S. Treasury maturities. Each U.S. Treasury security has a set maturity date and a current market-determined yield-to-maturity. Together, these points form a yield curve running from short-dated bills to long-dated bonds.

- What caused the yield curve to revert to its usual form?
- What does it mean for longer-term investors?

When we say that the yield curve is closer to its “usual” form, it has to do with the risk and return trade-off for bonds. Investors in longer-term Treasuries face more risk regarding inflation and real returns than investors in shorter-term Treasuries, so they usually demand a higher yield to compensate them for taking the extra risk. The accompanying exhibit shows the most recent yield curve along with the curve from last December (as of 12/18/06). In December, and for some time before and after that, the yield curve sloped downward and, except for the 20-year maturity bond, longer-dated Treasuries had lower yields than shorter-dated Treasuries. In effect, investors weren’t being compensated for the extra risk of owning longer-dated securities. This unusual yield curve inversion challenged investors to sort out the implications for the behavior and attractiveness of various fixed-income investments, including money market funds, bond funds and more traditional annuities.



U.S. TREASURY YIELD CURVE



Source: U.S. Treasury

There are a number of reasons that the U.S. Treasury yield curve can slope downward instead of upward. At the shortest end of the curve (not shown in the exhibit), the Federal Reserve Board gradually raised the overnight fund rate starting in 2003 from 1.0% to today's 5.25%. Other short-term interest rates or yields were naturally affected by the Fed's actions and rose along with the overnight rate.

Often, Fed actions at the short end can affect longer-term yields, but in this case had only a modest effect. That's because foreigners were still interested in a safe investment haven for recycling dollars they earn as a result of the current U.S. trade imbalance where we are importing more goods and services than we are exporting. As we know, the trade imbalance with China is particularly acute, and China is a leader in the international market for U.S. Treasury bonds. But China isn't the only Treasury bond buyer and, with demand for bonds remaining high, the prices investors were willing to pay remains relatively high, thus pushing down bond yields. In addition, inflation fears remain low. So while short-term yields are around 5%, heightened demand by foreigners were keeping longer-term yields between 4.50% and 4.75%.

We should note that the curve for 06/08/07 has just barely recovered from its previous inversion. The exhibit shows that shorter-term rates are a little below 5%, while the longest rates are a little above 5%. Moreover, the Fed

has kept the overnight funds rate—the shortest possible interest rate—at 5.25%, higher than all other Treasury rates with the exception of the 20-year bond. So the current yield curve is still not quite back to “normal.”

What has affected the new shape of the yield curve? You might think that it has to do with the U.S. economy. Good economic growth tends to drive up bond yields since in the past investors have worried that growth might push up inflation as well as borrowing of all sorts. However, although the prospects for the U.S. economy aren't bad, it is not exactly shooting the lights out at the moment. First quarter GDP growth was recently revised downward to a low annualized 0.6% and we expect that unemployment will begin to creep upward from 4.5% during the latter part of this year. So, the U.S. economy is hardly putting pressure on interest rates.

In fact, in this case the most important influence on the yield curve is foreign. Traditionally, the U.S. economy leads the world; when the U.S. economy slows down, so do many other countries' economies. But right now many European and Asian countries are experiencing higher economic growth than here in the U.S., and central banks in other countries have begun to raise their own short-term interest rates. Finally, the dollar has been falling against most other major currencies, meaning that Treasuries held by investors located in other countries are losing value to them (although new purchases are more attractive for that

same reason). All of these trends put pressure on U.S. rates to rise in order to continue to attract investors who have other places they can put their money.

The implications of these changes are rather important for U.S. investors. First, investors can't actually invest at the Fed funds rate, which is what the Fed charges banks for overnight borrowing. And with the longer end of the curve now paying more interest than the short end, we are beginning to see investors show a little less enthusiasm for money market funds that rely on highly liquid, short-dated fixed-income securities. Investors have noticed the difference and, according to the Investment Company Institute, asset flows to money market funds have decreased.

Second, since corporate bonds are heavily influenced by movements in the Treasury curve, yields on all bonds are rising modestly. Since bond mutual funds are marked to market every day, rises in bond yields are translated into a decline in bond prices. In turn, the returns on bond mutual funds have been moderating.

A third implication for investors is the domestic stock market. Until last week, the Dow Jones Industrial Average was up about 27% in the last year. Among other factors, the stock market has benefited from investors who see that low interest rates, high bond prices and low inflation expectations are good for corporate earnings growth. But now, as bond yields rise, bond prices and the dollar fall,

and inflation expectations are not as optimistic as they were, investors are perhaps a little less optimistic about corporate earnings. So the market experienced a few bumps last week.

A fourth indication has to do with annuities. For reasons previously mentioned, long-term investments such as annuities may become more attractive relative to bonds and money-market funds as interest rates rise. So, if the yield curve continues to return to its traditional form and long-term rates continue to rise, annuities that pay a guaranteed rate of interest may become a more attractive place to put new investment dollars. There are costs associated with annuities, including surrender fees, early withdrawal penalties and mortality risk expenses. Also, depending on the financial company you chose, the availability of specific types of annuities and annuity features may vary by state. So, always read the prospectus before investing.

As we can see, the effects of changes in the yield curve on investors are not always straightforward, especially as the economy and its capital markets become more global. So investors should consider carefully their actions in light of current circumstances.

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