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WHAT A FURTHER DOWNDRAFT IN HOUSING COULD MEAN TO THE ECONOMY AND FINANCIAL MARKETS

Over the past few months we have received a number of reports that suggest housing may be stabilizing. This apparent stabilization follows months of decline in that sector. But, are these better housing numbers of late just another false start, similar to what we saw last fall? Today, we will:

- Examine recent evidence suggesting the housing market may be firming, along with other data pointing in the opposing direction, to a further downdraft in that sector
- Argue, based on a host of indicators, that further weakness in housing is likely in coming months
- Discuss what a renewed housing downdraft could mean to the performance of the U.S. economy and financial markets during the second half of 2007

Let's first turn to why financial markets are now apparently discounting a stabilization of the housing market. Most importantly, some of the housing numbers have been better. In particular, we saw a rise in housing starts, new single-family home sales and mortgage applications during April. Also, employment increased at a reasonable pace, on average, during April and May, helping to increase the wherewithal of families to purchase homes.



Furthermore, home prices have declined dramatically in some localities (generally those that saw meteoric home price rises over the last few years) helping to increase housing affordability and clear out excess builder and realtor inventories of homes.

However, recent housing data also presents fairly strong evidence that the decline in housing is probably not over, that another bout of weakness is likely in coming months. More specifically, housing starts renewed decline in May following a string of monthly gains; single-family building permits (a precursor of future home building activity), weak for months on end, continued to fall in May; and ongoing weakness remained evident in home realtor and builder surveys. On top of that, mortgage lenders have tightened their standards for granting loans in the wake of the sub-prime mortgage debacle, thereby making it more difficult for home buyers, especially high-risk borrowers, to get credit. In addition, home prices have weakened for good reason: home inventories remain quite excessive, suggesting that home building activity will continue to decline until inventories decrease to more normal levels. And, if that's not enough, the recent run up in mortgage rates certainly will detract to some degree from home affordability and housing demand.

As a result, unlike what Wall Street is apparently thinking, we continue to expect another down leg for housing in coming months. This situation is not unlike what we saw last fall when the financial community thought housing had stabilized after seeing a number of economic reports that presented a more positive picture. Unfortunately, as we argued then, those improved reports were transitory in nature, reflecting the abnormally warm weather last fall, not a fundamentals-based improvement in the outlook for housing. While weather likely did not play a major role recently in presenting a better picture for housing, there is still plenty of evidence suggesting that another bout of housing weakness is imminent. Chronic declines in builder permits over the last several months; continued poor reports from realtors and builders; still-excessive home inventories; a renewed decline in housing starts in May; the tightening of mortgage lending standards; and the recent run up in mortgage interest rates, in our view, more than trump the more positive evidence financial markets have seized upon lately. Therefore, we view, unlike the current apparent financial market consensus, the chances

of another down leg to housing in coming months much more likely than not.

So, what would another period of housing distress mean to the U.S. economy and to financial markets?

First, the economy would likely be slower in the second half of this year than many people are apparently expecting. Many people, including those on Wall Street are now arguing, using the recent more positive evidence on housing (and discounting or ignoring data that housing is still in a down trend), that the economy will return to trend growth or beyond in the second half of this year. However, we believe (see the argument above) that the downdraft in housing has further to run. This means, in our view, that economic growth in the second half will come in lower than many on Wall Street now expect, not trend or higher growth as they expect, but rather a slightly below-trend result. And, from that slow-growth view flow a number of other important results. Sub-trend growth likely means that jobs over the second half probably will continue to decelerate, together with a rise in the unemployment rate to close to 5%. As a result, we expect inflation pressures to continue to abate, along with further actual moderation in "core" inflation (that is, inflation excluding food and energy price movements). In short, a still-slow sub-trend economy, largely due to a renewed drag from housing, probably means fewer job gains and less "core" inflation later this year than many in the financial community are now expecting.

And, we would likely see a number of fairly dramatic changes in financial market conditions, as the slow-growth scenario outlined above becomes increasingly likely. Recently, with the economy now expected to accelerate in the second half, the expectation of the Fed (Federal Reserve Board) lowering interest rates later this year has gone by the wayside. There are even some people on the Street, based on a forecast of stronger second-half growth, that argue that the Fed will actually tighten again later this year. We think differently, namely, that the Fed will likely maintain its current 5.25% Fed funds target over the remainder of the year, with little chance of their raising rates. This view, however, does not preclude the financial markets, in the midst of below-trend growth and moderating "core" inflation, of again entertaining the notion of the Fed lowering rates some later this year. Such a constellation (slow growth, moderation in inflation,

and a possible renewed expectation of Fed easing) would likely augur for bonds prices to rise (yields to fall) on average during the second half. More specifically, we are forecasting 10-year Treasury note yields to fall to around 4.6% by year-end from the roughly 5.13% we saw on June 22nd. And, with bond yields again falling in the U.S. but still rising elsewhere around the globe, we continue to expect continued downward pressure on the dollar exchange rate.

So, what about equities in this environment? While we do not have an explicit numerical forecast for major equity markets over the second half, we can discuss some possible implications of our slow-growth, lower inflation forecast for equities. First, lower bond yields may help to propel P/E multiples a bit higher. Counterbalancing (or overwhelming) that effect on equity market prices is

the slower earnings growth that is likely to flow from the slow-growth, lower inflation environment we are projecting. Indeed, it has long been our view that slower earnings growth could weigh heavily on equity market performance this year. Thus far, equities have done quite well this year, ignoring the slowdown in earnings. However, there is, in our view, still the possibility that slower earnings cut significantly into equity market performance over the remainder of the year.

In sum, there is, in our view, a significant chance of housing continuing to decline in the second half of the year. That decline, should it materialize, could keep the economy running at a subdued pace that could cause inflation to decline. Such a scenario could result in bonds rallying, dollar deprecating, and equity market performance deteriorating over the remainder of the year.

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