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GIVING MARKETS CREDIT

After hitting all-time highs in mid-July, the Dow Jones Industrial Average (the “Dow”) and the S&P 500 have fallen over 5% in a series of trading day gyrations. In the credit markets, high-yield “junk” bond spreads (the difference between their yields and the yields on comparable U.S. Treasury securities) have doubled over the last month. In addition, the Fed funds rate – the rate for overnight borrowing by banks – rose last week from its 5¼% target to about 5½%. Certain markets, such as higher-risk and jumbo mortgages and credit derivatives, seem to have seized up, with rising interest rates and few interested investors. And the Fed and the European Central Bank have both announced that they would make it possible for banks to borrow as much money as they need in the coming days and weeks.

- Behind the market turmoil lies investor uncertainty, as well as a general repricing of risk;
- Volatility may continue, especially in credit derivatives markets, but economic fundamentals haven’t changed all that much; and
- Individual investors should focus on what’s actually in their portfolios.

Breathtaking daily changes in equity markets, including swings of hundreds of points in the Dow, a one-day decline in the French stock market of over 3% (and significant equity market drops in many other countries around the globe), and the falling values of some financial services firms, might cause some of us to wonder whether such changes are unprecedented. And credit market problems, where a few mortgage-issuing firms have declared bankruptcy and some hedge funds have suffered severe and even debilitating losses, might reinforce such concerns.



Keep in mind some other market facts. Although the Dow and the S&P 500 have dropped, they are both off less than 7% from their July highs, which were truly all-time highs (at least in nominal terms). A rule of thumb used by many equity market observers is that a decline of about 10% should be considered to be a “normal” correction and that it takes a sustained decline of at least 20% to demonstrate the onset of a true bear market. In addition, market volatility tends to be asymmetric, which means that stock markets tend to rise more smoothly than they fall, so declines are more likely to be bumpy than increases.

Also keep in mind that although credit spreads have widened, especially for junk bonds, not long ago such spreads were near all-time lows, which means that the market seemed to place little value on the extra risk of such bonds compared to U.S. Treasuries or more highly rated corporate bonds. And the housing market, which took a turn for the worse with the end of several years of rapid price rises and easy mortgage credit, had become overheated with some of the lowest interest rates since the 1960s.

When we place current market conditions in context, they may not seem so unprecedented. But that doesn't mean that all is well, just that we should look carefully and realistically at the underlying forces.

Perhaps the most important of these is the economy. As we have said previously, the economy is far from overheated. In fact, last year we forecast that 2007 GDP growth would be about 2% (inflation adjusted), well below the long-term expected growth rate of a little over 3%. This contrasts with many other business economists, who forecast growth rates over 3%. We also anticipated the longer-term downturn in residential housing and expected that it would last for a while, when other expectations called for a short dip and then a recovery in that area. The true issue lies in the area of expectations. Although the economy is not in recession and there is a better than even chance that it won't sink into a recession over the next year, it hasn't met expectations. More specifically, housing market woes are deeper and more widespread than originally expected. So the contrast between expectations and reality may have weighed on financial markets.

In addition, it isn't clear to many investors just how deep and widespread credit market problems really are. The meltdown of two Bear Stearns hedge funds, the challenge faced by BNP Paribas in valuing the portfolios of three of their funds, and the drop in value of two Goldman Sachs hedge funds are all associated with difficulties in subprime mortgage and derivatives markets. In particular, collateralized debt obligations (CDOs) are structured products that package many mortgages and loans into securities purchased largely by institutions and some very high net worth individuals. The worry is that the subprime mortgage problems have infected CDOs so that it is hard to know what they are worth. And investors are additionally worried that some financial services firms could be in serious trouble if the credit derivatives problems are deeper than has so far been revealed.

At present, the three most important forces at work have to do with perceptions as much as anything else. They are (1) increased uncertainty, (2) increased risk and (3) a global repricing of risk. Recall that risk usually refers to relatively well-known probabilities, such as the chance that the stock market or bond defaults will rise or fall this year. In contrast, uncertainty is about the unknown, such as how problems in subprime mortgages will affect the overall markets. Investors aren't sure right now just how deep or widespread the effects will be so they may be more reluctant to purchase structured securities or hedge funds that might contain subprime securities.

In addition, market risk has increased, as indicated by the sharp upswing in market volatility. Investors are taking on a greater risk of a downturn in their investments compared to the last several years of relatively benign bond and equity markets.

Finally, although the economic outlook has not deteriorated significantly, investors are less willing to take on risk at the prices that prevailed until recently (e.g., low credit spreads and increasing stock market values). So markets have repriced risk as investors demand more compensation (higher credit spreads and lower equity prices) on their investments. And they have shown a tendency to move out of riskier investments into U.S. Treasuries and cash, thus tipping the yield curve once again as long-term rates have declined and the shortest-term rates have risen.

Which brings us to individual investment portfolios. TIAA-CREF portfolios contain little in the way of low-rated mortgages or CDOs based on subprime lending. More important, although markets can gyrate, we have seen that recent market volatility hasn't been outside of "normal" bounds. Instead, the current situation follows several years of less-than-normal volatility. Most important, long-term investors should not see market movements as a requirement to jump from one asset class to another. Instead, it may be a good opportunity for investors to review their portfolios, see whether their earlier asset allocation decisions still apply to their current circumstances and, if appropriate, rebalance to the desired asset allocation.

SUMMARY

Overall market gyrations and serious concerns in the subprime mortgage and derivative arenas are fueling investor concerns. However, current stock market volatility is not outside of "normal" bounds and investors may be reacting more to increased uncertainty than to changes in underlying economic or financial market conditions. Most individual investors are much less exposed to subprime mortgage and derivative investments than are institutions. They would be wise to examine their portfolios and desired asset allocations before attempting to leap into or out of any asset class.

TAKEAWAYS

- Behind the market turmoil lies investor uncertainty, as well as a general repricing of risk;
- Volatility may continue, especially in credit derivatives markets, but economic fundamentals haven't changed all that much; and
- Individual investors should focus on what's actually in their portfolios and their desired long-term asset allocation before attempting to leap in or out of individual asset classes.

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