

QUARTERLY MARKET MONITOR THIRD QUARTER 2007 ECONOMIC REVIEW

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THIRD QUARTER 2007 DEVELOPMENTS

UNITED STATES

Economic growth [as measured by growth of inflation-adjusted gross domestic product (i.e., real GDP)] likely slowed in the third quarter to a trend-like annual rate of 3%, after a 3.8% result in the prior quarter. This result is fairly consistent with our forecast for continued slow U.S. growth during the second half of 2007.

Moreover, this somewhat slower growth arose from a number of factors. First, on the positive side of the ledger, net exports continue to make a significant contribution and consumption, while somewhat slower than in Q2, held up quite well. Second, on the negative side, inventory investment likely detracted from growth, as did the ongoing drag from housing. And, finally, business investment probably grew less robustly during the quarter.

But with the U.S. economy slower, energy prices, on average, saw a sharp reduction during Q3, with the CPI for energy decreasing at almost a 15% annual rate. However, after the Fed rate cut in September, energy and other commodity prices bounced back again. Nonetheless, overall consumer inflation declined markedly during the quarter, with overall CPI inflation rising only at a 1% annual rate, sharply below the 5.2% rate of the prior quarter. But, at the same time, “core” CPI prices (those outside food and energy) rose a bit more in Q3, up at a 2.5% annual rate versus 2.3% in the prior quarter.



Given stable to moderating inflation and a slower economy, the Federal Reserve choose to cut its rate target by 50 basis points to 4.75% in mid-September, taking out some insurance against the economy sliding south in the wake of the late summer's financial markets convolutions and liquidity seizures.

EUROPE AND ASIA

Most economies outside the U.S. continued to perform pretty well during the last quarter.

In fact, the Euro area growth likely did somewhat better than the 0.3% quarter-to-quarter (not annualized) gain of Q2 (down from 0.8% in Q1). Industrial production held up well during the quarter, despite some erosion in business confidence and purchasing managers' surveys. In addition, broad money growth (as measured by M3) remained strong, still rising at an 11% year-over-year pace, more than double the 4.5% reference rate of the European Central Bank (ECB). But, in the wake of the sub-prime mortgage crisis (which apparently has had a significant adverse impact on European financial institutions), the ECB choose to remain on hold in September, after earlier signaling that it was poised to raise rates again that month.

With inflation below target, but the economy still fairly strong, the Bank of England (BoE) could have hiked interest rates again in September. But, as in the case of the ECB, the BoE choose to remain in a holding pattern in the wake of the U.S. sub-prime mortgage market liquidity crisis.

At the same time, Japan's economy seemed to improve a bit from Q2's very subdued 0.5% annualized growth result. Based on preliminary evidence, Q3's growth looks to have improved to near a 2% annualized pace, a pace that has prevailed on average for some time now. Again, as in previous quarters, the primary drivers of growth remain exports and business investment. Meanwhile, there is little evidence of inflation materializing in Japan. In fact, consumer prices have shown slight deflation recently. Moreover, with the economy not particularly robust and with the yen now somewhat stronger versus the U.S. dollar during last quarter, there is little reason to expect prices to rise sharply in Japan. And, with growth less-than-robust and

inflation virtually non-existent, there is little reason for the Bank of Japan (BoJ) to raise short-term interest rates.

Once again, China's economy continued to turn in a strong performance, even though Q3 growth is likely to be a bit slower than the stunning 11.9% year-over-year pace of Q2, mainly due to somewhat slower export growth arising from the economic slowdown in the U.S. and certain other developed countries. And as in most recent quarters, both investment activity and exports remained the main drivers behind this strong growth performance. Moreover, as in the past few years, the measures taken by the government (administrative controls, interest rate hikes, and reserve requirement increases) to slow the economy and the double-digit debt growth there still seem to have little effect during Q3. Meanwhile, inflation took another leg upward during Q3, with consumer prices showing a 6.5% year-over-year rise in August. This last leg upward is largely due to soaring meat prices, in part due to animal disease and contaminated products. This rise in inflation has been used by the People's Bank of China (PBoC) as a further opportunity tighten monetary policy (raise interest rates and reserve requirements) to slow the economy and quell any incipient rise in inflation. Unfortunately, from PBoC's viewpoint, such measures have yet to bear much fruit.

The trade-weighted dollar, in line with our long-held views, continued to slide in Q3, especially following the Fed's rate cut in mid-September. Not unexpectedly, the dollar depreciated less dramatically versus the Chinese yuan, since China's government only allows its currency to rise gradually versus the dollar.

Equity markets, even when faced with slower earnings, continued to rise early in the quarter, but faltered once investors' appetites for risk diminished in the wake of the sub-prime mortgage market liquidity squeeze. Only after the Fed cut interest rates in mid-September did equity markets rebound, ending the quarter on a more buoyant note. Meanwhile, bond markets languished, as equity markets marched higher early in the quarter. But, as the sub-prime mortgage liquidity crisis continued to mount, investors fled from equities into the safety of the Treasury fixed-income markets, particularly into short maturities. As a result, yields at the short end of the Treasury yield curve plummeted, showing much larger yield declines than seen

at the long end of the curve. The net result of these relative movements in yields was the Treasury yield curve becoming positively sloped again, after being slightly inverted (negatively sloped) for much of 2007,

FOURTH QUARTER 2007 GLOBAL ECONOMIC AND MARKET OUTLOOK

EXPECT U.S. GROWTH TO EDGE LOWER

A slow growth trajectory should continue in the fourth quarter.

- Given our long-held view that growth in the U.S. during the second half of 2007 would average 2.5% annualized and that our expectation of 3% growth for the third quarter materializes, growth in the fourth quarter should be about 2%.
- With growth remaining fairly slow, the unemployment rate should pickup over the remainder of the year from September's 4.7% level.
- But, oil prices and other commodity prices likely will rise some from current levels over the remainder of this year.
- Overall consumer price inflation will probably pick up some over the remainder of 2007 due to the recent rebound in energy and other commodity prices. On the other hand, with the unemployment rate edging higher, "core" consumer price inflation should be below 2% year-over-year by year end, not much of a stretch from the 2.1% year-over-year rate registered in September.
- Even with the economy a bit slower and "core" inflation edging lower, the Fed will likely remain on hold for the remainder of 2007, keeping its funds rate target at 4.75%. Only in the event of renewed financial distress or a significant faltering of the economy would the Fed again entertain easing. And, only if "core" inflation rises significantly would they tighten. Given the evidence at this point, the most likely stance appears for the Fed remaining in a holding pattern over the rest of 2007.
- The trade-weighted dollar will probably strengthen a bit near-term, as the expectation for further Fed easing dissipates

with the release of data showing the economy remains in reasonably good shape. However, before year-end, the dollar may resume weakening as expectations for a bit more tightening from the ECB take hold. Moreover, only expect modest weakening of the dollar versus the Chinese yuan, as China continues to tightly manage its currency.

- The Treasury yield curve will likely retain a positive slope over the remainder of the year as the Fed stays on hold.
- On the other hand, equity returns may erode as stock investors increasingly focus on fundamentals in the wake of recent financial turbulence. More specifically, equity returns over the remainder of the year will likely be diminished by investors now putting much more weight on the significant decline in earnings growth we have seen this year.

EURO AREA GROWTH LOOKS TO FINISH THE YEAR ON A SOFTER NOTE

Recent evidence suggests somewhat softer growth in the Euro area over the remainder of this year. Some of the major themes surrounding this view are:

- Euro-land growth will likely slow in the fourth quarter, evidenced recently by business confidence and purchasing managers' surveys eroding.
- Slower growth abroad, the cumulative effect of past interest rate hikes, and euro appreciation will cut into export growth and investment activity in the fourth quarter.
- Employment growth should slow with a softer Euro-land economy, limiting further improvement in the unemployment rate.
- A softer economy probably means inflation will become less worrisome to the ECB. However, broad money growth is still too robust for the ECB's taste, possibly prompting the ECB to raise rates again, especially with energy prices driving inflation higher.
- As expectations ebb for further Fed easing, the euro may weaken some from current levels versus the dollar near term, but should finish the year near our long-standing \$1.40 target.

U.K. ECONOMIC GROWTH WILL ALSO POISED TO SLOW

Similar to the Euro area, growth in the U.K. may soften in the fourth quarter. Some of the reasons for this are:

- U.K. inflation is now below the Bank of England's (BoE) 2% target. Also, in the wake of the U.S. sub-prime mortgage crisis, the BoE choose, along with the ECB, to remain on hold in September. However, with energy prices now rising sharply, there is a good chance that inflation will bounce above the BoE's target, prompting renewed BoE tightening, but probably by no more than 25 basis points by year end.
- The higher interest rates already in place have started to show through to U.K. housing activity. Housing activity looks like it has peaked, as evidenced by the decline in mortgage approvals in recent months.
- Softer housing means less home price appreciation in the fourth quarter. This in turn means that home equity wealth will grow less rapidly, cutting into consumer spending growth.
- And, we look for a near-term weakening of the British pound (GBP) versus the dollar (USD), as expectations of further Fed easing dissipates. However, the USD/GBP exchange rate should still be close to our \$2 target at year end.

STEADY AS SHE GOES IN JAPAN DURING THE FOURTH QUARTER

Japan's economy seems likely to continue on a fairly steady average growth track in the fourth quarter. The major reasons for this are:

- Earlier in 2007, investment and exports looked slower, but have shown tentative signs of reviving, helping to support growth near a 2% average annualized run rate. Both business investment and exports have been the main drivers of Japan's growth this year.
- Consumer spending, on the other hand, still shows few signs of accelerating, especially now that bonuses have been smaller. So, improvement in exports and business investment is key in supporting growth close to the 2% annualized growth rate we expect in Q4.

- With growth far from robust, inflation will likely remain quite subdued (recently consumer prices have shown slight year-over-year deflation), especially with money growth low (near 2% year-over-year).
- The BoJ will likely not raise interest rates for the foreseeable future, since consumer prices show slight deflation and the economy is far from strong.
- With the Fed likely not easing further, the yen should not appreciate much more versus the dollar.

CHINA'S ECONOMY WILL REMAIN STRONG, BUT THE FOURTH QUARTER SHOULD BE SLIGHTLY SLOWER

The major themes surrounding this view are:

- China's export growth has recently slowed, due to slowing in parts of the developed world, especially in the U.S. and Japan.
- The People's Bank of China (PBoC) has continued to tighten the monetary screws, hoping to rein in economic growth and mitigate developing inflationary pressures. Recently, in addition to raising interest rates and bank reserve requirements, it instituted administrative controls to limit bank loan growth in 2007 (recently rising at a robust 18% year-over-year rate). Specially, the PBoC cautioned banks to adhere to the PBoC's 15% year-over-year target for loan growth or face regulatory penalties. This means that average bank loan growth could slow markedly (to a mid-single digit quarter-to-quarter annual) in the fourth quarter. Of course, that assumes that the banks choose to adhere to the PBoC loan limits. But, if loan growth does slow to that degree, economic growth will likely be less robust in Q4.
- However, the fiscal authorities have more than enough financial flexibility (given that fiscal deficits are very low) to sustain growth at a politically acceptable rate. For instance, the fiscal authorities could accelerate spending on social programs (pensions, healthcare, education) and infrastructure to compensate for any growth shortfall arising from slower money growth or other areas (exports, business investment).

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And finally, we continue to look for only modest appreciation of the yuan (a.k.a renminbi), China's currency should only appreciate in 2007 by about 5% versus the U.S. dollar by year end.

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