

# QUARTERLY MARKET MONITOR SECOND QUARTER 2007 ECONOMIC REVIEW

**BRETT HAMMOND**  
CHIEF INVESTMENT  
STRATEGIST

**LEO KAMP**  
CHIEF ECONOMIST

**DOUGLAS FORE**  
DIRECTOR OF PORTFOLIO  
ANALYTICS

## Q2 2007 DEVELOPMENTS:

- Our long-standing, below-consensus growth forecast tracked well on average in the first half of the year, even though Q2 growth likely picked-up to about a trend-like 3% annual rate versus the 0.7% rate of the first quarter.
- Furthermore, the Q2 growth pick-up was not due to more vigorous final demand, but rather largely from increased inventory investment, although less drag from housing investment, increased business capital spending and net exports also helped. Importantly, consumer spending (70% of GDP) slowed significantly during the second quarter, likely registering just half the 4.2% rate of Q1 on an annualized, inflation-adjusted basis.
- Meanwhile, hiring continued to slow on average during the quarter.
- Overall consumer price inflation rose a bit in Q2 from the 4.7% annual rate of Q1, the result of energy, food and other commodity prices moving higher. But consumer price inflation outside of the food and energy areas (so-called “core” CPI inflation) remained stable in Q2 at the 2.3% annual rate we saw in Q1.
- With growth slow and only at a trend rate in Q2 and inflation moderating, the Federal Reserve (Fed) steered a steady course during the quarter, keeping its balance of risks assessment and 5.25% interest rate target unchanged.
- Economic growth outside the U.S. continued to do well, with the exception of Japan, whose growth seemed to remain stable at about a 2% annual rate. Growth accelerated during Q2 in the U.K. and in China, while Euro-area growth remained strong, albeit at a slightly less pace seen in Q1.



- The dollar, in line with our long-held views, continued to weaken in Q2, most dramatically versus the British pound and the euro. We also saw a bit more appreciation of the Chinese yuan (renminbi, RMB) versus the dollar, in part to head off rising criticism in Washington to the slow pace of appreciation since a more flexible RMB foreign exchange regime was introduced in mid-2005.
- Even in the face of a significant ebbing of earnings momentum this year, equity markets continued to charge ahead in the second quarter, setting new records in the United States. Bond prices, on the other hand, declined (yields rose) in response to the improved growth performance for the quarter and an evaporation of expected easing later this year by the Fed.
- The trade-weighted dollar will probably keep weakening on average over the balance of 2007, with narrower interest rate differentials and a gradual appreciation of the Chinese RMB being the main drivers behind that decline.
- European (including U.K.) growth could soften some in the second half, as slower growth abroad, higher interest rates at home and surging currencies cut into demand prospects.
- Meanwhile, economic growth in Japan will likely remain fairly stable, with investment and exports being 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 converges to a slower growth trajectory.

#### REMAINDER OF 2007 EXPECTATIONS:

- Despite a modest pick-up in the second half of the year, U.S. growth is expected to remain slow and below trend on average during that period, with an ongoing greater-than-consensus drag from housing investment preventing a significant acceleration.
- This below-trend performance should eventually result in the unemployment rate moving higher, towards 5% from its current 4.5% level.
- Not unlike the second half of 2006, overall inflation should moderate as energy, food and other commodity prices come off their recent peaks, as "core" inflation is less, and as a bit more slack in labor markets tempers wage gains.
- Looking at favorable growth and inflation prospects, the Fed will probably remain on its present track for quite a while, neither raising nor lowering short-term interest rates over the remainder of the year.
- Slow growth and moderating inflation auger well for a Treasury bond market rally during the second half. This probably means that the Treasury yield curve will likely re-invert (move to a small negative spread between longer and shorter term maturities) before the end of the year.
- On the other hand, equity returns may erode as stock investors increasingly discount the significant decline of earnings growth in train for this year.

#### SECOND QUARTER DEVELOPMENTS

##### UNITED STATES

Economic growth [as measured by growth of inflation-adjusted gross domestic product (i.e., real GDP)] likely picked-up in the second quarter to a trend-like annual rate of 3%, after a 0.7% result in the first quarter. Nonetheless, growth for the first half probably came in a bit below even our below-consensus 2% expectation. So overall, our forecast for subdued growth in the U.S. during the first half of the year remained completely intact.

Moreover, the modest acceleration we saw in the second quarter arose not from a vigorous ramp-up in domestic demand. First, much of the improvement was due to a further buildup of inventories. Also, growth benefited during the quarter from a reduction in the drag from housing, business capital spending doing better and net exports improving. However, consumer spending (representing 70% of GDP) decelerated sharply in Q2, to an inflation-adjusted rate of about half the 4.2% annualized pace seen in Q1.

But despite a more sluggish U.S. economy, energy prices and other commodity prices continued to move higher in Q2. Oil prices rose from the mid-\$60s range into the low-\$70s range. Most metal and food prices also moved higher during the quarter. As a result, overall consumer

inflation picked-up during the quarter, with overall CPI inflation rising at a 5.2% annual rate, a bit higher than the 4.7% rate of the first quarter. Meanwhile, “core” CPI prices (those outside food and energy) rose in Q2 at the same 2.3% annualized rate seen in the first quarter. Even with the rise in overall CPI inflation, the Federal Reserve held fast to its interest rate target of 5.25% throughout the quarter. While still alert to inflation increasing, the Fed seems quite pleased with the economy’s slower performance recently and the possible implication of inflation remaining well-contained flowing from that slower growth trajectory.

### EUROPE AND ASIA

In most places outside the U.S., economic growth continued to do quite well in Q2.

During the quarter, the Euro area growth likely eased a bit from the 0.8% it saw in Q1, but still remaining well above trend. Again, Germany seemed to lead the other “Big Three” countries in terms of growth. Moreover, consumer price inflation in the Euro area remained a bit below the 2% upper limit of the European Central Bank’s (ECB’s) target range for inflation, averaging about 1.9% year-over-year (Y/Y) during the quarter. However, broad money growth remained too strong for the ECB’s taste, registering more than twice their 4.5% speed limit. Given the ECB’s monetarist bent inherited from the traditions of the prior German Bundesbank, rapid money growth of that magnitude represents an important upside inflation risk to the ECB, enough to keep them tightening through the end of this year and perhaps beyond.

With inflation still above target, and the economy accelerating a bit to a 0.8% quarter-over-quarter (not annualized) pace in Q2, the Bank of England (BoE) continued to raise rates in Q2, even though year-over-year consumer price inflation receded a bit during the quarter. With home prices still rising briskly and consumer spending doing well, in the BoE’s mind, there remains a significant risk that inflation will rise well beyond the already uncomfortable rate of inflation in the region.

Meanwhile, economic growth in Japan seemed to be about the same last quarter as in the previous quarter, close to 2%. Both business investment and exports appear now to be on a less vigorous growth trajectory, at the same time

that the consumer again turned in unimpressive results. With the economy less vigorous, inflation continued to be low, with year-over-year nationwide CPI inflation remaining close to zero. With the economy slower and inflation low, the Bank of Japan (BoJ) has little “cover” or justification for moving interest rates higher (repo rate is currently at 0.5%), especially in an aggressive manner.

And again, China’s rapid growth continued unabated during the quarter, coming in at 11.9% Y/Y for the quarter. The same old drivers, investment activity and exports, that have been propelling there for quite some time remained in place during the second quarter. Moreover, the measures taken by the government to rein in growth (administrative controls, interest rate hikes and reserve requirement increases) still have had little effect in dampening economic and debt growth there. In addition, inflation rose during the quarter with consumer prices rising at an above 4% Y/Y in June, but mainly to food prices ratcheting higher (partially the result of animal disease reducing meat supplies). But, with the economy booming and inflation higher, it is very likely that further (albeit gradual) measures will be taken to quell growth in China.

The dollar, in line with our long-held views, continued to weaken in Q2, most dramatically versus the British pound and the euro. We also saw a bit more appreciation of the Chinese yuan (renminbi, RMB) versus the dollar, in part to head off rising criticism in Washington to the slow pace of appreciation since a more flexible RMB foreign exchange regime was introduced in mid-2005.

Even in the face of a significant ebbing of earnings momentum this year, equity markets continued to charge ahead in Q2, setting new records in the U.S. Bond prices, on the other hand, declined (yields rose) in response to the improved growth performance for the quarter and an evaporation of expected easing later this year by the Fed.

## 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.

## QUARTERLY MARKET MONITOR

# SECOND QUARTER 2007 ECONOMIC REVIEW

- Economic growth will continue at a slow rate in the second half at about a 2.5% average annualized run-rate, with housing activity continuing to exert higher-than-consensus direct and indirect drags on growth.
- Not unlike what we saw in the second half of 2006, oil prices and other commodity prices will likely decline some from current levels as we progress through the remainder of 2007.
- With growth remaining slow, the unemployment rate will pickup, rising towards 5% by year-end, up from the 4.5% rate seen recently.
- Overall consumer price inflation will continue to drift lower as commodity prices ease some and labor markets become less tight. "Core" consumer price inflation should be below 2% Y/Y by year end.
- Even with the economy slower and inflation somewhat lower, the Fed will likely stick to its recent stance, keeping the Fed funds rate target at 5.25%. Only in the event of a financial crisis or recession would the Fed ease. And, only if "core" inflation rises significantly would they tighten.
- The trade-weighted dollar will probably continue its weakening trend over the remainder of 2007, as interest rate differentials narrow between the U.S. and the rest of the world and as China's currency gradually appreciates versus the dollar.
- The Treasury yield curve will likely re-invert (move to a modest negative spread between longer and shorter term maturities) before the end of 2007, mainly due to an expected bond rally in the second half due to slower growth and lower inflation.
- On the other hand, equity returns may erode as stock investors increasingly discount the significant decline of earnings growth in train for this year.
- 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 likely see some additional appreciation, ultimately reaching at least \$1.40/euro 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 BoE, 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.

### 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:

### 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.

### 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.

**Market Monitor is prepared by TIAA-CREF Asset Management and represents the views of TIAA-CREF's Investment Strategy and Client Solutions Group. These views may change in response to changing economic and market conditions. Past performance is not indicative of future results. The material is for informational purposes only and should not be regarded as a recommendation or an offer to buy or sell any product or service to which this information may relate.**

TIAA-CREF is a national financial services organization and the leading provider of retirement services in the academic, research, medical and cultural fields with over \$400 billion in combined assets under management (12/31/06). Further information can be found at [www.tiaa-cref.org](http://www.tiaa-cref.org).

TIAA-CREF Asset Management is a division of Teachers Advisors, Inc., a registered investment advisor and wholly owned subsidiary of Teachers Insurance and Annuity Association (TIAA). TIAA-CREF® personnel in its investment management area provide investment advice and portfolio management services through the following entities: Teachers Advisors, Inc., TIAA-CREF Investment Management, LLC, and Teachers Insurance and Annuity Association® (TIAA®). TIAA-CREF Individual & Institutional Services, LLC, distributes securities, member NASD/SIPC. TIAA, TIAA-CREF, Teachers Insurance and Annuity Association, TIAA-CREF Asset Management and FINANCIAL SERVICES FOR THE GREATER GOOD are registered trademarks of Teachers Insurance and Annuity Association.

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](mailto:cpeterson@tiaa-cref.org).

C39226