

# MARKET MONITOR 2007 YEAR-END REVIEW

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## 2007 YEAR-END REVIEW: GLOBAL SLOWDOWN, GYRATING MARKETS AND FLIGHT TO QUALITY

2007 began mildly for both the economy and the financial markets. US GDP growth slowed to about 2%, well below long-term trends, and financial market volatility was considerably below average. But later in the year, volatility increased for both. After a good third quarter, the US economy slowed to an annualized growth rate of about 1%. Financial markets followed a similar pattern, with two short periods of global equity volatility followed by strong returns. Then, in November, most stock markets turned steeply negative. At the same time, fixed-income returns rose as investors sought safety in U.S. Government bonds.

### GLOBAL SLOWDOWN

Since 2005 the global economy has been slowing unevenly, with the most visible declines in two of the world's largest economies, the United States and Japan.

The rest of world has continued on a fairly robust growth track. This resilience has been apparent in Europe's major economies, the United Kingdom and the Euro-area, but has been stronger in most emerging economies. Growth in most emerging markets has been universally strong in recent years, with China consistently posting nearly double-digit real growth rates for the last two or three years. Other emerging economies have also done well, with India and the Philippines approaching China's growth rates.

So, as we entered 2007, the U.S. and Japan were already beginning to slow, while much of the rest of the world had not. As 2007 progressed, the U.S. and Japan continued to slow further while growth elsewhere remained robust.



**United States**

In the United States, growth tailed off during the year to an annualized pace of just over 2%, about three quarters of a percentage point below the almost 3% posted in 2006. The economy dropped considerably in the second quarter, rose at a robust 4.9% rate in the third quarter, and is expected to come in at about a 1% annual rate in the fourth quarter.

Much of the growth-rate downtrend in the U.S. was due to an intensifying housing slump and a meltdown in the sub-prime mortgage market. In the wake of that mortgage debacle, many large financial institutions had to take large write-downs of their sub-prime mortgage investments, significantly reducing their capital positions. As a result, financial institutions substantially increased their scrutiny of mortgage originations and investments and raised their interest rates on these loans. Furthermore, home builders and sellers of existing homes continued to cut prices to reduce inventories that had become excessive. These price reductions, while increasing the affordability of housing, reduced the equity of existing homeowners, and likely were partly responsible for the reduction in consumer spending growth during the year.

In addition, U.S. corporate earnings growth, which only a year ago was in double digits, decelerated rapidly and for

Q3 dropped into negative territory on a year-over-year basis for the first time in many years.

**Japan**

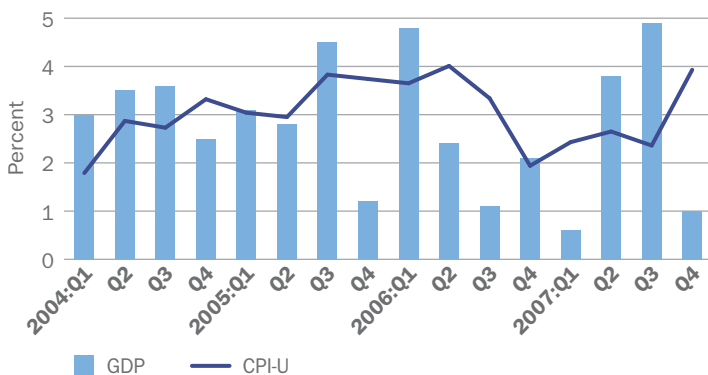
Japan saw an erratic erosion of growth during the year. After posting a high growth rate late in 2006 (5+% in Q4), the economy moderated in the first quarter (to over 3%), actually declined by almost 2% on an annualized basis in the second, and posted an anemic rebound (up 1.5%) in the third quarter. While official data are not yet in, evidence suggests that growth in the fourth quarter is likely to remain unimpressive. All in all, Japan in 2007 probably turned in growth below the 2.2% reading we saw for 2006.

Meanwhile, growth in Europe continued to improve, in spite of the softer results in the U.S. and Japan.

**United Kingdom**

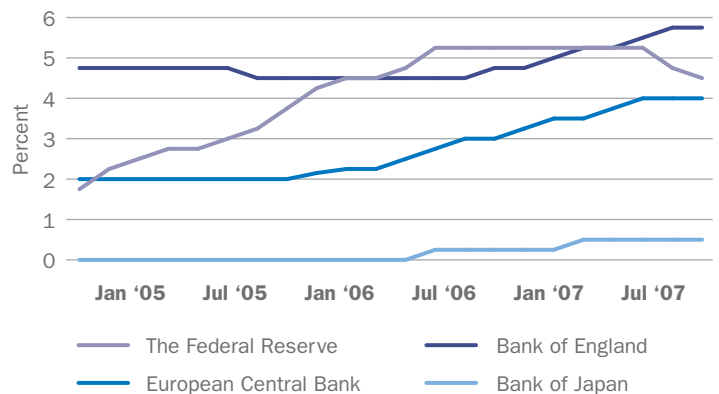
The economy in the United Kingdom continued to hum, posting real GDP growth a bit higher than the 2.8% level of 2006. Household spending on homes and consumer products and services continued to do well, despite rises in interest rates by the Bank of England during most of the year. During that time, home buying was vigorous, and home prices continued to rise at a double-digit year-over-year pace. Only toward the end of the year did the interest rate hikes seem to cause home buying to slow. With the slowdown in housing, the Bank of England cut rates late in the year.

**U.S. ECONOMIC GROWTH (GDP) AND INFLATION (CPI-U)**



Source: U.S. BEA and BLS

**GLOBAL SHORT TERM INTEREST RATES**



Source: ICM-RA

### Europe

Growth held up exceptionally well in the Euro-area in 2007, benefiting largely from the still-vigorous growth outside the U.S. and Japan. Germany did especially well focusing on capital goods exports, many of which flowed to rapidly growing emerging market economies, including China and India. With strong economic and monetary growth, the European Central Bank (ECB) raised interest rates during most of the year. Only after the U.S. sub-prime mortgage crisis impeded global liquidity later in the year did the ECB cease raising rates and inject large amounts of funds to ease the tight liquidity conditions.

### Emerging Economies

The most spectacular growth stories for 2007 were not in the developed countries (such as the Euro-area or the U.K.) but among the emerging market economies. China's economy continued to soar, turning in about 11% growth for the year; India saw growth near 9%. Moreover, other emerging economies did quite well, with many (especially those in Asia) posting growth in high single-digits.

### Global Inflation

Despite still vigorous growth in many parts of the world and further rises in energy prices, inflation in most places remained well contained. In the U.S. overall inflation during most of the year stayed below 3% year-on-year. However, there was a (likely transitory) blip upward inflation later in the year (to over 4%) due to energy prices. In comparison, "core" inflation (which excludes energy and food) remained subdued, coming in at just over 2% year-on-year. Inflation also remained reasonably well behaved elsewhere in developed countries.

Nonetheless, inflation picked up in certain developing economies. In China, inflation soared to almost 7% late in the year from the 1% to 2% seen earlier, largely due to sharp increases in food prices. In India inflation rose earlier in the year but receded by mid-year. Mexico and Brazil started to see rises in inflation late in the year, probably due to sharp energy price increases. Nonetheless, inflation, with a few exceptions, remained reasonably well contained in emerging economies, especially given their hefty economic growth rates.

The year 2008 should see continued slowing of the global economy with well-contained inflation. Much of the slowdown will come from those areas that have not yet slowed much.

Consequently, we expect Europe and parts of Asia (including China) to be a bit weaker, compared to an improving growth trend in 2008 for the U.S. Overall, we expect the global economy to see somewhat slower growth in 2008.

## FINANCIAL MARKETS

### Equities

Equity market returns were solid for most of the year until November, with three exceptions. In April, global equity markets, reacting to economic slowdowns in some markets and to bubble conditions in China, dropped sharply but recovered quickly. Similarly, in August, led by the U.S., stock markets turned volatile in recognition of the first major announcements of the effects of the subprime mortgage meltdown on financial services firms.

In November and December, stock market volatility returned with a vengeance. The Chicago Board of Exchange VIX (a measure of expected S&P 500 volatility) rose to a measure of 31, about 10 points above its long-term average.

Equity investors began to shed riskier assets in favor of the safety afforded by U.S. Treasuries. In particular, the broad S&P 500 and Russell 3000 domestic indexes fell more than 3% since the beginning of October, and as a result were up only just over 5% for the year.

This year the value-growth cycle turned dramatically. After six years of underperforming value stocks, large-cap growth equities (Russell 1000 Growth) returned close to 12% for the full year, even after having dropped during the fourth quarter. In contrast, large-cap value equities (Russell 1000 Value) plummeted nearly 6% for the quarter and were slightly lower for the year. Similarly, small-cap stocks (Russell 2000), which had beaten large-cap stocks for several years, were down about 4.5% for the quarter and about 1.5% for the year, reflecting the market's turn away from value and smaller-cap stocks. The worst performing index in the table was the Dow Jones-Wilshire RESI (representing REITS), which reflected continued revelations about residential mortgages by falling over 13% during the fourth quarter.

Toward the end of the year, equity investors shifted their focus toward company fundamentals. After the recent

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volatility in equity markets, investors seemed to place increasing emphasis on the earning power of companies in valuing their stock.

On the international side, the broadest global and foreign stock indexes — MSCI World and MSCI EAFE — were also down for the quarter. Nevertheless, for the year, the MSCI EAFE index handily beat all other equity indexes except for large-cap growth stocks. The falling dollar, continued corporate restructuring, and commodity extraction activities in other countries helped foreign equities strongly outperform U.S. equities for the last two years.

### Fixed Income

The attraction of Treasuries and other fixed-income securities was evident. Investors often treat all Treasuries as a safe haven in volatile times; the last few months have been no exception. Treasury Inflation-Protected

Securities (TIPS) beat all other indexes for the year, except for the large-cap growth index, perhaps due to their dual guarantee: full faith and credit of the U.S. government and the link between yield and CPI. All other major fixed-income indexes were positive for the quarter and for the year. Notably, the broad Lehman Aggregate Bond, TIPS, and short-term bond indexes exceeded the returns of all major equity indexes.

In sum, the return of market volatility in the latter half of 2007 is sharply evident in equity returns, even though most equity indexes remain positive for 2007, with foreign and large-cap growth stocks leading the pack. The growing attraction of bonds is reflected in recent fixed-income returns, especially in TIPS. If current trends continue, investors will grow increasingly discriminating as they look for good prospective company earnings or the safety of government bonds.

### SELECTED MARKET INDEX RETURNS (%)

INDEX	FOURTH QUARTER 2007	YTD
S&P 500	-3.33	5.49
Russell 3000	-3.34	5.14
Russell 1000 Growth	-0.77	11.81
Russell 1000 Value	-5.80	-0.17
Russell Mid-Cap	-3.55	5.60
Russell 2000	-4.58	-1.57
DJ Wilshire RESI (REIT)	-13.68	-17.85
MSCI World	-2.32	9.04
MSCI EAFE	-1.75	11.17
Merrill Lynch BB-B Cash Pay (High-Yield)	-0.37	3.18
Lehman Bros. Aggregate Bond	3.00	5.97
Lehman Bros. TIPS	4.97	11.64
Lehman Bros. Short Govt/Credit Index	3.53	7.27
iMoneyNet Taxable All Average (Money Market)	1.10	5.10

### OTHER INDICATORS

	1/2/07	12/31/07
Fed Funds Rate	5.25	4.25
10-Year Treasury Bond Yield	4.68	3.91
30-Year Mortgage Rate	6.18	6.07

**Market Monitor is prepared by TIAA-CREF Asset Management and represents the views of TIAA-CREF's Investment Strategy and Client Solutions Group as of December 31, 2007. 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.**

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