

# WEEKLY MARKET MONITOR JANUARY 28, 2008

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## UPDATE ON RECENT GLOBAL ECONOMIC DEVELOPMENTS

### UNITED STATES

While final economic reports for 4Q are not in yet, U. S. economic growth (measured in inflation-adjusted GDP terms) slowed significantly late last year, with the fourth quarter growing (at annual rates) only at 0.6%, sharply down from almost 5% in Q3. The low Q4 growth rate increases considerably the risk of the economy falling into recession.

The slowdown was focused in inventory investment and in a continued drag from housing. However, net exports, business capital, government spending, and consumer spending made positive contributions to growth in the quarter. With growth significantly slower, it was not too surprising to see employment slow, especially in December when the unemployment rate rose 0.3 percentage points to 5%.

Meanwhile, we saw a sharp rise in energy prices and an escalation of so-called “core” prices (those outside food and energy) during the quarter, with overall CPI inflation coming at 4.1% year-over-year in December and “core” CPI inflation registering 2.4% year-over-year. Both of these inflation results are higher than what we saw in Q3.

But despite inflation being higher, the Fed chose to continue to cut interest rates during the quarter, largely to shield the economy from a downdraft resulting from the tightened liquidity conditions and increased volatility seen in financial markets during the quarter. So, at quarter’s end, the Fed’s funds target stood



a full percentage point lower than the 5.25% rate that prevailed prior to September 18th, when the Fed first started easing. Meanwhile, the Treasury market rallied strongly during the quarter as the Fed eased and as more risk adverse investors shunned equities and corporate bonds in favor of the safety provided by Treasury issues. So, it was not too surprising to see the dollar fall sharply during the quarter as short-term interest rates fell with Fed easing, Treasury bond yields declined sharply, and U.S. economic growth waned (recession fears rose) during the quarter.

## EUROPE AND ASIA

During the fourth quarter, Euro-area growth appeared to have held up quite well, even in the face of increased financial market volatility around the globe. As a result, growth there will probably come in close to the 0.7% quarter-to-quarter rate seen in Q3, probably again largely driven by exports and business capital spending. However, inflation rose to above 3% during the quarter, more than a full percentage point above the European Central Bank's target, and money (M3) growth (at 11%) remained much too strong for the ECB's taste. As a result, future ECB tightening can not be ruled out, despite the fact that the ECB suspended its program of interest rate hikes during Q4, due to the tightened liquidity conditions and increased financial market volatility that was so evident during the quarter. And, of course, the euro soared versus the dollar in the wake of increased financial market volatility and the Fed ease that resulted from those conditions.

U.K. growth probably was a bit softer in Q4, mainly due to housing activity slowing sharply and home prices declining, both of which hurt household wealth and helped slow the economy during the quarter. And, compared to expectations earlier last year, the Bank of England cut interest rates in the final quarter, largely to support growth in the face of a faltering housing market. This is despite CPI inflation being a bit above the Bank's 2% year-over-year target.

Meanwhile, economic growth seemed to have softened somewhat in Japan during Q4, despite a less than robust growth result in the prior quarter. Business investment and exports seemed to have softened some, despite still mixed results from spending by households. Moreover, inflation

remained subdued at year-end, with CPI inflation near 0.5% year-over-year, and this is despite a significant recent run up in energy prices. So, with the economy softer and inflation low, there is really no reason to expect the Bank of Japan to raise interest rates further. This is especially true given heightened political uncertainty there.

Meanwhile, China continued to roar in 2007. Economic growth in the final quarter of last year came in at a 11.4% year-over-year rate. As in prior years, much of the robust growth there was driven by soaring investment activity. Obviously, policy measures, especially money policy measures, had little effect in slowing investment in China last year. The reason for this is that the principal driver of corporate capital spending is corporate cash flow, which has remained extremely strong. Therefore, the measures that Chinese government and central bank have taken to dampen vibrant investment demand there have had little impact thus far.

## 2008: VERY SLOW UP FRONT, BETTER IN THE SECOND HALF

### EXPECT U.S. GROWTH TO BE VERY SLOW EARLY ON, BUT IMPROVE MODESTLY LATER

The slower growth trajectory that emerged in the U.S. late in 2007 will likely persist into the early part of this year.

- Economic growth will likely be slow in the first half, as recent declines in housing activity continue to exert direct and indirect drags on economic growth here. Declines in housing activity will directly cut into overall economy-wide growth early in year. During that same period, consumer spending will likely be subdued as weak equity markets and declining home prices erode household wealth. Nonetheless, the economy is expected to improve in the second half, as the drags from housing become much smaller. Moreover, a recession is not expected, although low growth rates early in the year make the economy vulnerable to negative shocks pushing it into recession.
- Oil prices and other commodity prices will likely be more stable in 2008, although there is a possibility of selected commodity price declines during 2008, especially in the first half.

- The unemployment rate will likely pickup, on average, in the early quarters, but may decline some later as the economy improves in the second half.
- Overall and “core” inflation should drift lower as commodity prices cease rising (or show only modest increases) and labor markets become less tight.
- With the economy slower and inflation well under control, the Fed will likely ease more early this year, but may take some of that ease back as the economy improves in the second half. Nevertheless, we do not expect the Fed to ease throughout the entire year, but rather look for them to reverse gears and tighten a bit before year end.
- The Treasury yield curve should remain positively sloped throughout this year, but less so in the second half if the economy improves and the Fed starts to tighten to take back some the ease it put in place in late 2007 and early this year.
- The trade-weighted dollar will probably continue to weaken in 2008, but less so compared to prior years, especially during the second half as the economy improves here, as interest rate differentials narrow between the U.S. and rest of the world in the second half, and as China’s currency appreciates at a faster pace.
- And, employment growth should be slower with a softer Euroland economy, limiting further improvement in the unemployment rate.
- A softer economy may mean that inflation may effectually become less worrisome to the European Central Bank (ECB). This could prevent the ECB from resuming raising interest rates, although they probably would also like to see a significant moderation in money (M3) growth (running at an 11% annual rate recently). Indeed, without inflation receding to targeted levels and a significant reduction in M3 growth, we could very well see further limited tightening from ECB this year to maintain their anti-inflation credibility, even with a somewhat softer economy.
- Government budgets will continue to be pressured by greater retirement and medical spending, as the populations of major Euroland countries age and decline in numbers.
- The euro will likely see further appreciation versus the dollar this year, especially if the ECB resumes tightening.

### EURO AREA GROWTH SHOULD SOFTEN THIS YEAR

Despite growth recently holding up quite well, we look for somewhat softer growth in the Euro area this year. Some of the major themes surrounding that view are:

- Euroland growth should continue to do pretty well in the face of other developed economies’ growth, especially in the U.S., remaining subdued. Again, much of the growth there will be sourced from exports and investment, especially for Germany. And, as has been the case for some time now, consumer spending will likely continue to disappoint as a growth driver.
- Growth should soften around mid-year as the effects of slower growth abroad, past interest rate hikes, and euro appreciation cut into export growth and, derivatively, into investment activity.
- Past interest rate hikes by the Bank of England appeared to have slowed housing activity there and have resulted in home price declines in recent months.
- Softer housing activity and weaker home prices should result in a slower economy this year, probably near 2% versus the roughly 3% likely posted for 2007.
- Lower home prices mean that home equity is declining, not rising, which in turn suggests that consumer spending this year will be slower.
- And with the U.S. economy slow and the British pound seeing sharp gains over the past two years, it’s likely that exports will also slow some this year, thereby also detracting from overall growth in 2008.

### U.K. ECONOMIC GROWTH LOOKS TO BE SLOWER THIS YEAR

Growth in the U.K. economy will probably also soften some this year. Some of the reasons for that view are:

- Inflation, which has moderated significantly lately, should moderate further with the slower economy there this year.
- Finally, we expect less appreciation of the British pound versus the dollar this year, principally due to the Bank of England probably lowering interest rates a bit this year, in their quest to support U.K. economic growth in the face of slow U.S. and global growth and a weakening domestic housing market there this year.

### SOFTER GROWTH PROSPECTS FOR JAPAN

Economic growth in Japan this year will likely be softer than last, closer to 1.5% rather than the 2% pace that has prevailed for a while. The major reasons for this are:

- Japan's growth this year will edge down some as the rest of the world slows and as recent yen appreciation starts to be felt. Growth this year will likely be closer to a 1.5% average annualized run rate, a bit slower than the 2% that has been in place over the past couple of years.
- However, the composition of growth in Japan will likely remain fairly stable this year, with exports and investment being the main drivers, albeit growing at a slower pace.
- Moreover, consumer spending will continue to disappoint as a growth driver, especially now that labor market conditions has softened a bit and political uncertainties continue to mount with the demise of LDP control.
- As a result, inflation will likely remain very subdued, even with energy prices now elevated. This is especially so given that money growth remains fairly low (around 2%) and the yen is stronger.
- With inflation very low and the economy softer, the Bank of Japan will likely remain on hold for a long time.
- With little movement in interest rates and the economy slower this year, it is unlikely that we will see much further appreciation of the yen versus the dollar, although some appreciation may still occur.

### CHINA'S ECONOMY WILL REMAIN VERY STRONG, ALTHOUGH A BIT LESS VIBRANT COMPARED TO LAST YEAR

The major themes surrounding that view are:

- China's export growth will likely be a bit less robust as much of the developed world sees somewhat slower economic growth. Nonetheless, even with a growth hit to exports from slower developed economies, the overall economy there is expected to still grow at a double-digit pace (10–11%) this year.
- With inflation rising well above 6% year-on-year in the closing months of 2007, we expect more serious policy moves to rein in economic growth a bit this year and to alleviate food production shortfalls (recently inflation has been driven by sharp increases in food prices due largely to shortages of meat and eggs). So, we especially look for more stringent monetary policy moves by the People's Bank of China, including a faster pace of interest rate and reserve requirement hikes and more administrative curbs on bank loan growth.
- China continues to resurrect a social safety net, but thus far with only limited success. It will take considerable time before positive results from these programs impact economic growth. Moreover, it will take time for people to regain their trust in the government regarding such programs. Therefore, consumers will probably maintain their high rate of precautionary saving for a considerable time into the future, making the government's goal of shifting towards a more consumer-driven economy more difficult.
- And finally, we look for the Chinese yuan to appreciate at a somewhat faster pace compared to recent years, as the government now sees more rapid appreciation as a tool for reining in economic growth to more acceptable rates, to prevent economic overheating and inflation rising to still higher, intolerable, levels.

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