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1Q 2008 ECONOMIC DEVELOPMENTS:

- The U.S. economy fell into a modest recession during the first quarter of 2008, after posting an anemic 0.6% annualized gain for real GDP in the fourth quarter of last year. Real GDP for the first quarter grew by the miniscule amount of 0.6%. Despite this sluggish growth, there is still plenty of evidence to support calling for an economic recession, due to the three consecutive monthly declines in payroll employment and an unemployment rate that hit 5.1% in March (up from 5% in December).

- Inflation ticked upward in 1Q08, with headline CPI inflation rising (from a three-month annualized rate of 3% in December to 3.1% in March) due to soaring food and energy prices. However, excluding those items, core CPI inflation actually declined to a 2% annualized rate during the quarter from the 2.7% reading in the final quarter of last year. Meanwhile, almost all economies experienced a rise in headline inflation during the quarter mostly due to sharp energy and food price increases (with food prices being a large inflationary driver in emerging economies).

- Elsewhere, global growth was quite mixed during 1Q08. For instance, the Japanese and U.K. economies slowed, while Euro-area growth held up quite well, and growth in the emerging market economies generally maintained a fairly robust pace. (Although China saw some slowing due to slower export growth and weather-related production disruptions, growth there was about a percentage lower than the stunning 11.4% year-over-year pace at year end last year.)

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- In the wake of the subprime mortgage meltdown contagion spreading from the U.S., global financial markets continued to be volatile during the quarter and investors, looking for safety, piled into U.S. Treasuries, shunning stocks and corporate bonds (even those of investment grade quality, but especially high-yield issues). These conditions induced the Fed to continue cutting interest rates and employ innovative measures to inject liquidity into capital markets. Unlike the Fed, other major central banks did little to change their monetary stance during the quarter.

UPDATE ON 2008 EXPECTATIONS

STAGNANT U.S. GROWTH TO CONTINUE WITH KNOCK-ON EFFECTS TO THE REST OF THE WORLD

- The U.S. economy likely will remain in recession through the first half, as declines in housing persist and as consumption and business investment weaken. Moreover, despite fiscal stimulus lifting 2Q08 activity and ending the recession by the third quarter, growth for the remainder of the year will remain subdued, sustained only by the lagging positive effects of the massive Fed easing put in place earlier in the year.

- With many economies sluggish or slowing, oil prices and other commodity prices will likely stabilize this year, with even declines possible in some categories.

- The U.S. unemployment rate will likely continue to increase this year, rising close to 6% by year-end, the result of growth being anemic and significantly below trend over much of the year.

- Inflation around the globe should drift lower as commodity prices stabilize and labor markets become less tight.

- In this environment, the Fed will likely ease more on April 30, but will probably remain on hold for the remainder of the year. And, with the economy stagnant and inflation under control, we don't see the Fed raising interest rates this year. Other major central banks (particularly in Europe) will only ease gradually (as with the Bank of England) or only late this year (as with the European Central Bank). On the other hand, the People's Bank of China will likely continue tightening financial conditions, using traditional monetary policies (raising interest rates and reserve requirements) and administrative controls on lending.

- The Treasury yield curve should continue to display a positive slope during much of this year. But, with the economy looking somewhat better (but still anemic) and the Fed on hold during the second half of 2008, long-term Treasury bond yields could tick up during that period.

- The trade-weighted dollar will probably decline during 2008, as the gap between the U.S. and the rest-of-the world's interest rates narrows in the second half, and as China allows its currency to appreciate at a somewhat faster pace.

UPDATE ON RECENT GLOBAL ECONOMIC DEVELOPMENTS

UNITED STATES

Based on the deterioration in a wide range of indicators, the U.S. economy lapsed into recession during 1Q08. The onset of the recession in the first quarter resulted from weakness in consumption, housing, and business capital spending. However, net exports and inventory investment made positive contributions to growth in the quarter. With growth significantly slower, it was not surprising to see payroll employment decline in each of the three months during the quarter and the unemployment rate rising to 5.1% in March (versus 5% in December).

Meanwhile, we saw a sharp rise in food and energy prices during the quarter that caused overall (or headline) CPI inflation to rise to 3.1% on a three-month annualized basis (versus 3% in December) and remain high at 4% year-over-year. CPI inflation outside of the food and energy areas (so-called core inflation) moderated significantly on a three-month annualized basis to 2% in March (compared to 2.7% in December), but remained uncomfortably high, from the Fed's perspective, at 2.4% year-on-year.

But despite inflation remaining elevated, the Fed cut interest rates aggressively during the quarter, in the hope of mitigating any economic downdraft resulting from tightened liquidity and credit conditions and increased financial market volatility. At quarter's end, the Fed's funds target stood a full three percentage points below the 5.25% rate that prevailed prior to September 18, when the Fed initiated easing. In addition, the Fed undertook additional measures to increase liquidity in financial markets, some of which were quite innovative (including its facilitation of the acquisition of Bear Stearns by JPMorgan Chase).

Meanwhile, the Treasury market rallied during the quarter as the Fed continued to ease and inject liquidity, and as more risk-adverse investors shunned equities and corporate bonds in favor of default-proof Treasury issues. So, it was not very surprising to see the dollar continue its slide in 1Q08 with short-term interest rates falling, Treasury bond yields declining, and the U.S. economy entering into recession.

EUROPE AND ASIA

During the first quarter, Euroland area growth appeared to have held up quite well, even in the face of increased global financial market turmoil. As a result, growth there will probably come in a bit better than the 1.4% quarter-to-quarter rate seen in 4Q07, again likely driven by exports and business capital investment. However, inflation remained significantly above 3% during the quarter, much more than the 2% maximum targeted by the European Central Bank (ECB). Also, money (M3) growth remained much too strong (still in double digits) for the ECB's taste. While future ECB tightening can not be ruled out, the ECB remained on hold after suspending its program of interest rate hikes during 4Q07 in the wake of the tightened liquidity and credit conditions and increased financial market volatility.

U.K. growth was a bit softer in 1Q08 versus last year's final quarter when real GDP growth registered a 2.5% quarter-over-quarter annualized rate. A sharp slowing in housing activity and home price declines are largely responsible for the quarterly slowdown. Moreover, home price declines have hurt household wealth and caused consumption to slow, helping to slow the broader economy further. With this emerging economic malaise, the Bank of England cut interest rates a bit further during the quarter, in an effort to support growth in the face of a weakening housing market. Unlike the Fed, the Bank of England embraced a gradual path to easing, due to CPI inflation remaining above the bank's 2% year-over-year target and rising.

Meanwhile, after posting annualized growth of 3.5% in the prior quarter, sluggish economic conditions again seemed to have taken grip of Japan's economy in 1Q08. Business investment and exports softened some, along with continued, subdued spending by households. Moreover, inflation rose, but nonetheless remained subdued by international standards, with CPI inflation near 1% year-over-year in March, despite a significant run up in global energy prices. But, despite renewed economic sluggishness and low inflation, the Bank of Japan choose to maintain its monetary stance, not raising or lowering interest rates.

Meanwhile, China's economy continued to grow at a robust, year-over-year pace in the first quarter. However, growth during the quarter was about one percentage point below the 11.4% year-over-year rate posted in 4Q07. Much of the first quarter slowing can be attributed to slower exports (with actual declines to the U.S.) and to weather-related disruptions in output. As in prior periods, much of the robust growth there was driven by strong investment activity. Obviously, policy measures, especially monetary policy measures, had little effect in slowing investment in China. The reason for this is that up until recently, the principal driver of corporate capital spending has been strong corporate cash flows. Therefore, the measures that the Chinese government and central bank have taken to dampen vibrant investment demand there have had little impact thus far.

2008 UPDATE: VERY SLOW (EVEN RECESSIONARY) UP FRONT AND ONLY SLIGHTLY BETTER LATER

EXPECT U.S. GROWTH TO BE VERY SLOW EARLY ON AND SHOW ONLY MODEST IMPROVEMENT LATER

- The recession that emerged in the U.S. during the first quarter will likely continue through the second. However, with fiscal stimulus in the form of tax rebates kicking in during May, the second quarter could get a lift from that program. Moreover, the impact of the stimulus will likely be felt significantly during the third quarter and may result in the recession ending. Nonetheless, the fourth quarter is likely to again see a relapse into fairly anemic growth as the uplift from the stimulus package wears off. Anemic growth in 4Q08 is also likely, due to ongoing distress in housing markets, weak employment, subpar business investment and a renewed weakness in consumer spending. Moreover, such anemic growth makes the economy vulnerable to renewed recessionary conditions arising from adverse “shocks” such as another spike in energy prices, physical disruptions in energy supplies, and additional financial market distress. And, a recessionary or sluggish U.S. economy will adversely affect, to varying degrees, other economies around the world.

- With growth softer, oil and other commodity prices should eventually stabilize and, even decline, in coming quarters.
- The unemployment rate will likely pick up towards 6% as we progress through the year, the result of slower growth.
- Overall and core inflation should drift lower as commodity prices stabilize (or decline) and as labor markets become less tight.
- With the economy slow and inflation under control, the Fed will likely remain on hold after cutting rates again on April 30 to evaluate the effects of the massive monetary stimulus already put in place.
- The trade-weighted dollar will probably continue to weaken on average this year, but less so compared to prior years, especially during the second half as the economy shows modest improvement, as interest rate differentials narrow between the U.S. and rest of the world, and as China’s currency continues to appreciate.

EURO AREA GROWTH SHOULD SOFTEN THIS YEAR

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

- Euroland growth should slow on average for the remainder of the year, but hold up well compared to other major economies. As in the past, growth this year will be supported by exports and business investment, albeit at a softer pace. However, housing is softening in certain economies in Euroland, most notably in Ireland and Spain and, to a lesser extent, in France. This housing malaise will detract from growth there this year. And, as it has been the case for some time, consumer spending will continue to disappoint, particularly in Germany.
- Growth should soften around midyear as slower growth abroad, past interest rate hikes, euro appreciation, and softer housing converge to have a significant overall slowing effect.
- With a softer Euroland economy, employment growth should be slower, limiting further improvement in the unemployment rate.
- A softer economy means that inflation will become less worrisome to the European Central Bank (ECB). This will prevent the ECB from resuming raising interest rates, although they would also like to see with the slowing economy, a significant moderation in inflation and in money (M3) growth (running just over an 11% annual rate recently). Indeed, without inflation receding to targeted levels and a significant reduction in M3 growth, the ECB may maintain its current monetary stance (of a 4% rate target) for the remainder of 2008.
- The euro will likely see some further appreciation against the dollar this year, mainly as an aftereffect of aggressive Fed easing earlier in the year.

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

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

- Past interest rates hikes by the Bank of England and a U.K. fallout from the U.S. subprime mess has slowed housing activity there considerably, resulting in home price declines.
- Softer housing activity and weaker home prices should result in a slower economy this year, probably near 1%.
- Consumer spending in the U.K. this year will be slower. Lower home prices mean that home equity is declining, leading to less home equity loans and slower consumption growth by U.K. households.
- And the U.S. economy slows, Euroland’s economy softens, and the British pound soars, it’s likely that British exports will also slow this year.

- Inflation has risen significantly on the heels of soaring commodity prices (especially energy). However, inflation should moderate going forward, the result of the slower economy there and more stable global commodity prices this year.

- Finally, we expect less appreciation of the British pound against the dollar this year, principally due to the Bank of England lowering interest rates gradually, and the Fed being on hold for the rest of the year.

SOFTER GROWTH PROSPECTS FOR JAPAN

Economic growth in Japan this year will be softer than last. The major reasons for this are:

- Japan's growth this year will edge down as the rest of the world slows and as the yen's appreciation starts to be felt. Growth this year will be closer to a 1%–1.5% average annualized run rate, a bit softer than the 2% that has been in place over the past couple of years.

- However, the composition of growth in Japan will look similar to the recent past with exports and investment being the main drivers (although weaker) and household spending remaining disappointing.

- Despite rising inflation in Japan because of higher energy and food prices, inflation will remain very subdued (close to its current 1% rate) given the softer economy. This is especially so given that money growth remains fairly low and the yen has strengthened recently.

- With inflation subdued and the economy softer, the Bank of Japan will likely remain on hold during this year.

- With little movement in interest rates and the economy slower this year, it is unlikely that we will see the yen strengthening significantly further, versus the dollar on average, for the rest of the year, especially if the Fed and the Bank of Japan remain on hold during the second half.

CHINA'S ECONOMY WILL REMAIN ROBUST, BUT SOMEWHAT LESS VIBRANT COMPARED TO 2007

The major themes surrounding that view are:

- China's export growth will likely be less robust as much of the developed world sees somewhat slower economic growth. Nonetheless, even with slower growth in exports from underdeveloped economies, the overall economy there is expected to grow at a lower double-digit pace (around 10%) this year.

- With inflation rising to almost 9% on a year-on-year basis in February, look for continued policy moves to rein in economic growth this year and to alleviate food shortages. So, we look for monetary policy tightening further by the People's Bank of China, including interest rate and reserve requirement hikes, and more administrative curbs on bank loan growth. Moreover, to alleviate food shortages and lower prices , various incentives to increase food supplies (including "health insurance" for pigs) have been put in place.

- 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 and preventing inflation from increasing.

SOURCE: TIAA-CREF ASSET MANAGEMENT

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