

WEEKLY MARKET MONITOR MAY 12, 2008

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SUMMARY

An overall 25 percent decline in the value of the U.S. dollar and a 4 percent U.S. inflation rate are related concerns connected to global financial imbalances associated with loose U.S. fiscal and monetary policy, rising commodity and food prices throughout the world, and shifting demand by foreigners for U.S. Treasuries. We are not soon likely to see a dollar as strong as it was in the early part of this decade as the world's financial markets take some time to adjust to the current global imbalances. The effects could continue to be difficult in the short to medium term and the outlook for financial markets is mixed.

THE DECLINING DOLLAR AND INFLATION: WHERE DO WE GO FROM HERE?

Recently, the U.S. Dollar reached an all time low versus the Euro. Today, the dollar hovers near 0.65 Euro, which means the Euro is worth about \$1.55, nearly double what it was a few years ago when foreign goods seemed cheap. Similarly, the British Pound is currently valued a little under \$2.00 after a rapid rise in 2007. The dollar floats freely against these currencies, but even the government controlled Chinese Yuan (renmimbi) has risen more than 15 percent against the dollar in the last couple of years.



To make matters worse, for the past several months the U.S. Consumer Price Index (CPI) has been running at an annualized rate over 4 percent, nearly double the rate of just over a year ago and well above what most countries consider to be an acceptable modest inflation rate.

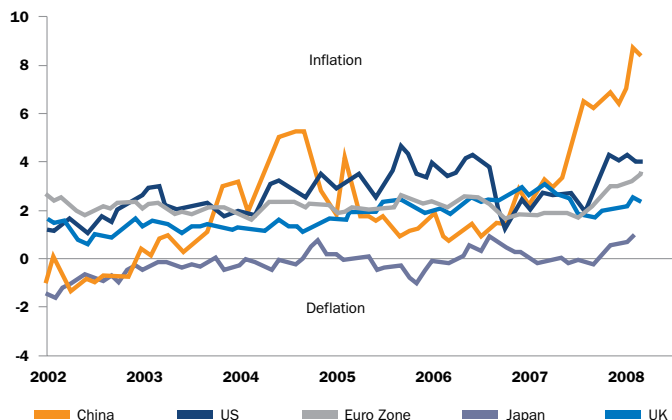
This week we want to zero in on currency and inflation, specifically:

- The origins of a falling dollar and rising inflation;
- The relationship between currency values and inflation; and
- What these trends mean for financial markets over the long run.

The dollar and inflation rate are, in fact, related, since some fundamental economic forces underlie both trends. First, the prices of commodities — especially energy, metals, and food — have risen in the last couple of years to all time highs. On the demand side, robust economic growth, especially in important developing countries (e.g., Brazil, Russia, India, China, and others), raised worldwide demand for these and other goods. On the supply side, production of many basic goods did not keep pace with demand. For example, world oil production has remained remarkably steady even though prices have doubled in the past few years. Second, during a time when the U.S. Federal Reserve might have been raising interest rates in order to contain rising prices, the Fed instead lowered rates and took other emergency measures to combat the current liquidity crisis in the financial markets. The Fed has apparently decided to tolerate a somewhat higher inflation rate for the time being in order to combat current weak economic growth.

While these measures may ease financial and economic strains, they do little to hold down prices, and through a weaker dollar, will likely exacerbate price rises. The following chart shows the uptick in inflation in the U.S. and in several other major economic markets around the world. Note that China has experienced a significant rapid rise in prices.

CONSUMER PRICE INDEX
YEAR OVER YEAR PERCENT CHANGE

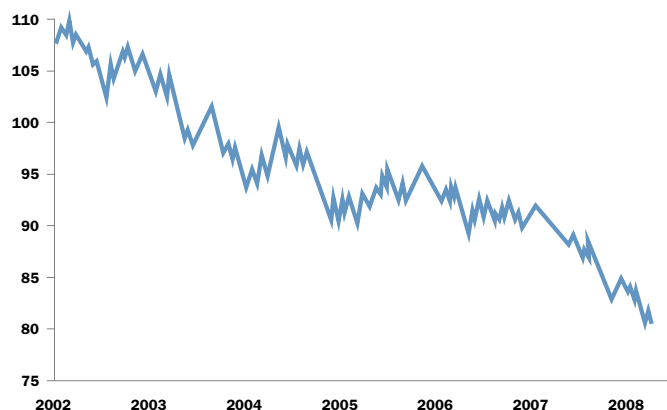


While these changes could easily account for rising prices and inflation, what do they have to do with the value of the dollar? Demand for dollars was high for many years as foreigners sold goods and services to the U.S. and used the dollars they received to purchase and hold vast amounts of U.S. Treasuries and other financial assets. In addition, world oil and other commodity sales are generally denominated in dollars, so that even foreigners were required to buy dollars in order to purchase these commodities. These are major examples of the dollar's continuing use as the world's reserve currency. Further, although most of the large country currencies around the world are allowed to float freely against each other, some countries, such as China, and some regions, such as the Gulf oil nations, manage their currencies in order to keep the value of the dollar artificially high versus their currencies.

In the current decade, significant changes began to occur in world economic and financial markets. The U.S. ran increasingly large trade and current account deficits. In essence, this means that the U.S. was consuming and investing much more every year than it was producing. This excessive consumption and investment was financed by borrowing from the rest of the world. In addition, U.S. policymakers embarked on a triple strategy of loosening fiscal and monetary policy (i.e. tax and interest rate cuts), while increasing federal spending. Spending increases and tax cuts were financed by issuing more Treasury bonds purchased by foreigners, especially foreign central banks. The interest rate cuts helped fuel a bubble in the housing market, with the kind of results we have all seen.

This worked for a while, but the large and growing imbalances in trade (the U.S. purchases far more goods and services than it exports) and the current account (foreigners purchase far more U.S. financial securities than they sell to the U.S.) put pressure on financial markets to adjust. One of the major adjustment mechanisms in a world where most currencies float freely was the value of the dollar. As the following chart shows, the value of the dollar versus an index of other currencies (each currency is weighted by how much trade the U.S. does with the respective country) dropped from nearly 110 in 2002 to just over 80 today. This represents a decline of over 25 percent. A declining dollar reflects the fact that the cost of foreign lending to the U.S. in order to finance our deficits is going up.

U.S. DOLLAR EXCHANGE RATE BROADLY DEFINED TRADE WEIGHTED (JPMORGAN)



This means, of course that dollars are worth less today in other currencies than they were a few years ago. It also means that U.S. goods, services, and financial securities are worth less, relative to their foreign counterparts. That is good news for foreigners who wish to purchase new goods and securities, but bad news for foreigners who are holding securities, such as U.S. Treasuries they purchased when the dollar was worth more. In contrast, it is good news for Americans who are holding foreign securities or who are selling goods and services abroad, but bad news for Americans who wish to purchase new foreign goods, services, and securities, since they are likely to cost more in dollars than they did before.

In the end, the declining dollar may help world financial markets reduce the imbalances caused by large current account deficits and loose fiscal and monetary policies. Other things being equal, U.S. exports and financial flows will increase, relative to imports, since the weak dollar will make U.S. goods, services and securities relatively cheap for foreigners to buy. Similarly, foreign exports to the U.S. will decrease relative to U.S. exports, since it will be relatively more expensive for foreigners to buy.

In the interim, it is possible, even likely, that the dollar will not soon rise to levels anywhere near where it was in the early part of this decade. If foreigners are selling relatively fewer goods, services, and securities to the U.S., they will receive fewer dollars that will need to be recycled. For example, with fewer dollars and low interest rates in the U.S. the demand by foreigners for U.S. Treasuries, for example, could be reduced. Further, other countries, such as China, are beginning to shift their foreign reserves more toward riskier investments and away from U.S. Treasuries.

In such a scenario, it is also possible that inflation could continue due to the rising prices of foreign goods and services and reduced demand for U.S. goods and services. In this case, we could see later in 2008 or 2009 rising interest rates to combat inflation and to attract continued foreign financial flows. If so, then we could see some pressure on bond prices and a decidedly mixed outlook for equities.

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