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LEO KAMP
CHIEF ECONOMIST

SUMMARY

ECONOMIC LANDSCAPE IN THE SECOND QUARTER

- U.S. economic growth probably improved during Q2, with real GDP growth likely to come in at 2.5% annualized, a substantial improvement over the first quarter's 1% annualized rate.
- Outside the United States, incipient economic slowdown became increasingly evident.
- Most economies around the globe saw inflation continuing to climb, propelled by soaring energy prices and robust food price increases.
- The Fed eased in April, but went on hold for the remainder of the quarter, largely due to a greater perceived risk of inflation increasing. Most central banks in other developed countries were also on hold during the quarter.



FINANCIAL MARKET PERFORMANCE IN Q2

Financial markets remained turbulent last quarter, weighing more heavily on equities than bonds.

- The Dow Jones Industrial Average returned -6.85% during Q2, while broader indexes, such as the Russell 3000® (-1.69%) and S&P 500® (-2.73), generally fared somewhat better.
- Value stocks significantly underperformed growth in the United States with the Russell 3000 Value Index dropping 5.17% while the Russell 3000 Growth Index managed to gain 1.51%.
- A number of foreign equity markets also endured substantial pain last quarter. The broad-based MSCI EAFE® Index continued its decline although less dramatically than in the first quarter.
- Pacific-Rim stocks made considerable improvements from the significant negative returns of the prior quarter.
- The MSCI Emerging Markets Index did not decline as much as the developed country indexes during the quarter, perhaps reflecting a leveling out from a significant rise in the Q1, some economic slowdown there, and rising risks from tighter monetary policies.
- Bonds, even default-free Treasuries, fared poorly in the quarter, posting negative returns and partially offsetting significant gains from Q1.

LOOKING AHEAD

U.S. growth may relapse into recession-like conditions; slowdown in the rest of the world may become increasingly apparent.

- After the uplift from the fiscal stimulus fades, the U.S. economy will likely return to an extremely sluggish growth trajectory in Q4, one coming very close to recession.

- The global slowdown will intensify, especially if many developed country central banks continue to hold or (in the case of the ECB) edge interest rates higher.
- Recent oil prices and other commodities prices are likely unsustainable.
- The unemployment rate in the United States should continue to rise from the 5.5% seen in June, approaching 6% by year-end. Unemployment rates elsewhere globally are also likely to tick higher as below-trend growth takes hold in many developed economies, except in still-robust emerging market economies.
- Inflation may peak later this year, as this slowing process causes wage and commodity price inflation (especially energy) to decline modestly around the globe.
- The Fed will likely remain on hold during the remainder of the year. However, if the economy does not slow or inflation remains high, the Fed may gradually hike rates late in 2008. Other central banks will probably remain on hold for now, but are more inclined than the Fed to hike rates.
- If the United States returns to near-recession status and inflation starts rolling over, the Treasury yield curve will probably flatten some before year-end, with much of the action being at the long end (10-year maturities and above).
- In such an environment, the trade-weighted dollar will probably be under downside pressure, despite our expectation that other economies will also be slowing at that time.
- The expected slower growth environment points to less-than-stellar equity market returns going forward.
- Bond returns, however, should improve as inflation moderates globally.
- With ongoing turbulence still likely, investors should continue to focus on the long term, avoid market timing, and diversify holdings to help mitigate risk.

RECENT GLOBAL ECONOMIC AND FINANCIAL MARKET DEVELOPMENTS

UNITED STATES

Second quarter economic growth will probably come in at an annual rate near 2.5% (versus 1% in Q1). However, that improvement was due almost exclusively to a massive fiscal stimulus (\$100 billion in so-called “tax rebates”) during the quarter. Even with that stimulus, economic growth still experienced substantial drags from weaker home building and prices, turbulent and declining equity markets, lackluster business capital spending, and deteriorating labor markets. Hence, our view is that the economy in the United States was still fundamentally weak in Q2, despite the apparent improvement arising from the stimulus. Indeed, throughout the quarter, jobs losses continued to mount (with the unemployment rate at 5.5% in June versus 5.1% in March) and consumer confidence continued to fall, both of which point to ongoing weakness in consumer spending.

Even though the U.S. economy remained fundamentally weak, consumer inflation continued to roar ahead last quarter, propelled by soaring energy prices and rising food prices. Versus the same month last year, the overall Consumer Price Index (CPI) was up 5% in June, a full percentage from just three months prior. But with the economy fundamentally weak and financial markets still stressed, the Fed cut its target rate by 25 basis points on April 30. However, after that cut, the Fed became increasingly concerned about inflation rising and decided to go on hold for the remainder of the quarter, taking time to evaluate how the large monetary stimulus already in place is affecting economic growth, financial markets, and inflation going forward.

Financial markets remained turbulent last quarter, with equities experiencing greater volatility than bonds. But, with the Fed on hold and inflation rising, Treasury bond yields rose during the quarter. Additionally, equity markets, after poor performance in Q1, again weakened during the second quarter. This comes as no surprise due to the fundamentally slow economy, rising commodity inflation, and continued reporting of large financial write-offs.

Reflecting these equity losses, the Dow Jones Industrial Average returned -6.85% during Q2, while broader indexes, such as the Russell 3000® (-1.69%) and S&P 500® (-2.73), generally fared somewhat better. Value significantly underperformed growth in the United States, with the Russell 3000 Value Index dropping 5.17% during the quarter while the Russell 3000 Growth Index managed to gain 1.51%. Growth consistently beat value last quarter regardless of capitalization size (large-, mid-, or small-cap). These performance differentials were likely due to investors fleeing from turbulent financial stocks, which are heavily represented in the Dow index and in the value universe, into the perceived safety of growth stocks showing consistent earnings momentum (e.g., pharma) or robust price gains (e.g., energy).

Due to higher energy and food price increases pushing overall inflation higher, bonds (even default-free Treasuries) fared poorly during the quarter. Nonetheless, while also generally posting negative returns last quarter, many bond categories did better than broad equity markets. But, with inflation roaring ahead, gains in the first quarter were not sustained in the second quarter and most bond categories posted negative returns. For instance, the Lehman U.S. Aggregate Bond Index returned -1.02% during the second quarter and 1.13% year-to-date, better than the Russell 3000 quarter-on-quarter (-1.69%) and, especially, year-to-date (-11.05%). U.S. Government bond returns were all in negative territory for the quarter, with the Lehman U.S. Government Bond Index returning -1.91%. High-yield bonds, however, significantly outperformed U.S. government issues, with the Lehman Corporate High-Yield Index returning 1.76%, up significantly from the approximate 3% decline in the first quarter.

EUROPE AND ASIA

In Q2, Europe probably slowed quite a bit, with manufacturing production and orders ebbing, housing distress becoming apparent in certain areas (like Spain and the United Kingdom), and purchasing managers' indexes (economic activity gauges) now flashing contraction rather than expansion. This apparent deterioration in economic performance during Q2 was especially dramatic in the euro-area given that real GDP growth during Q1

ran at an above-trend annual rate of 2.8%. Moreover, a similar deterioration in economic indicators, likely means that Japan also slowed significantly in Q2. Even historically fast-growing emerging market (EM) economies probably slowed some last quarter, in many cases as the result of slower exports, ebbing corporate profits constraining investment, higher inflation cutting into consumer demand, and tighter monetary policies. Indeed, for these reasons, China, the poster child for EM economies, saw real GDP decelerate to a 10.1% year-over-year pace in Q2 from 10.6% in Q1.

And, although economic weakness started to become more visible in Europe last quarter, both the United Kingdom and the euro-area saw CPI inflation continue to climb higher, mostly due to rising food and energy prices. The United Kingdom and euro-area CPI inflation reached 3.8% and 4% respectively year-over-year in June, up from 3.6% and 2.4% in March. Even Japan, which only emerged from mild deflation early last year, likely saw higher consumer inflation through June (perhaps coming in at 1.5% year-on-year). However, China actually saw lower inflation due to the impact of last year's rapid food price increases starting to dissipate, with year-over-year CPI inflation there down to 7.1% in June from 8.3% in March.

In developed countries outside the United States, most central banks were on hold during the quarter due to inflation moving uncomfortably higher. The European Central Bank strongly hinted near the end of the quarter at a rate hike to combat rising inflation. And, the People's Bank of China continued to raise bank reserve requirements, also in an effort to stem higher inflation.

U.S. financial markets did not suffer alone last quarter, as a number of foreign equity markets also endured substantial pain. First, the broad-based MSCI EAFE® Index declined an additional -2.25% last quarter, on top of an almost 9% negative hit in the first quarter. European markets were especially disappointing with the MSCI Europe Index returning -4.15% last quarter versus a more than 8% decline in the first. The downdraft in Europe likely reflects, as in the United States, the poor performance of financial companies (banks, insurers) exposed to the global

meltdown in structural asset prices (CDOs, RMBS, etc.) On the other hand, Pacific-Rim stocks did considerably better last quarter, with the MSCI Pacific Ex Japan Index and the MSCI Japan Index returning 1.48% and 2.47% respectively, both improvements over the significant negative returns of the prior quarter. This relatively better performance likely reflects the lower exposure of financials in that region to the troubles in structured assets globally as well as a partial rebound from significant declines in the first quarter. Even the MSCI Emerging Markets Index did not decline as much as the developed country indexes (-0.86%) during the quarter, perhaps reflecting a leveling out after a significant increase in the first quarter due to some economic slowdown there and, more importantly, the rising risks from the tightening of monetary policy in those economies where inflation has become a major policy issue.

FORECAST FOR THE REMAINDER OF 2008: SLOWDOWN TO CONTINUE AROUND THE GLOBE

RE-EMERGENCE OF SLOW GROWTH FOR THE UNITED STATES

We believe the United States will see a re-emergence of extremely sluggish growth in the third and fourth quarters of 2008 for the following reasons:

- As the uplift from fiscal stimulus fades early in the second half, the U.S. economy should return to an extremely sluggish growth trajectory by Q4, one coming very close to recession. The reappearance of anemic growth in Q4 will likely be due to ongoing distress in housing markets, still turbulent financial markets, weak employment, sub-par business investment, almost record low consumer sentiment, and a renewed sag in consumer spending. Moreover, such anemic growth makes the economy vulnerable to renewed recessionary conditions arising from adverse "shocks" such as another energy price spike or physical disruptions in energy supplies.
- Overall and "core" inflation should drift lower as commodity prices stabilize (or even decline) and as labor markets become less tight.

- With economic growth and inflation risks now roughly balanced, the Fed will likely remain on hold for much of the rest of 2008 to evaluate the effects the massive monetary stimulus already put in place. However, a rate hike to combat inflation later this year cannot be ruled out.
- The dollar will probably weaken further on average over the rest of the year, due to the re-emergence of weakness here, the narrowing of bond yield differentials between the United States and rest of the world, and a continued (but managed) appreciation of the Chinese yuan versus the dollar.

EURO-AREA GROWTH TO SOFTEN MORE LATER THIS YEAR

We expect the now visibly softer growth in Europe to soften further over the remainder of the year. Major themes surrounding that view are:

- Euro-area real GDP should continue to decelerate during the remainder of the year for a number of reasons, including: the lagged adverse effects on euro-area export competitiveness from the sharp appreciation of the euro since 2002, emerging housing problems in Spain, Ireland, and (to a much lesser extent) in France, monetary tightening by the European Central Bank (ECB), and slower exports due to slower growth outside the euro-area.
- With the euro-land economy slowing further, employment growth there should slow and the unemployment rate should stop improving (and maybe rise a bit).
- A softer economy may prevent the ECB from being very aggressive in hiking interest rates. However, the ECB is more likely to hike (albeit gradually) now than in the recent past, due to the continued run-up in inflation (now twice their target) and the ongoing strength of money growth (with M3 growth still near 11%, more than twice the ECB's 4.5% target).
- Due to weakness in the U.S. and bond yield declines, the euro will likely be under upward pressure versus the dollar over the remainder of the year, especially in the fourth quarter as the United States becomes visibly weaker.

UNITED KINGDOM ECONOMIC GROWTH SET TO SOFTEN FURTHER THIS YEAR

United Kingdom economic growth should soften further over the rest of this year. Some the reasons for this are:

- Bank of England interest rates increases in the past, the fallout in the United Kingdom from the U.S. structured asset debacle, a sharp housing activity and price turndown, and softer exports due to weaker euro-area growth, all mean that growth in the United Kingdom should finally be much more subdued this year than last.
- Consumer spending in the United Kingdom will likely be more subdued this year, the result of home prices and household home equity eroding substantially. Less home equity extraction means that consumption growth there will probably be much less this year.
- Inflation is up significantly this year, mainly due to soaring commodity prices (especially energy). However, as the global economy slows further throughout the year, commodity prices and overall inflation in the United Kingdom should moderate later in the year.
- However, with inflation high and still likely to rise some, the Bank of England will likely edge interest rates higher over the remainder of the year.
- Finally, we expect some additional appreciation of the British pound versus the dollar this year, due to the re-emergence of very weak economic conditions in the United States near the end of the year, lower U.S. bond yields, and gradual Bank of England tightening.

SOFTER GROWTH PROSPECTS FOR JAPAN

Japan's economic growth will likely soften over the remainder of 2008 due to major contributing factors such as:

- Japan's growth prospects continue to deteriorate due to the adverse effect of slower global growth on exports, less buoyant profits causing weaker investment growth, and a consumer that is still reluctant to step up to the spending plate in a big way. As a result, we expect slowing over the remainder of the year to translate into 1%–1.5% growth for 2008 as a whole, down significantly from the approximate 2% run-rate of recent years.
- Japan's growth drivers will likely remain the same (although growing at a slower pace): exports and business capital spending.
- As in other countries, Japan's inflation of late has been higher in comparison to the recent past as the result of soaring global commodity prices. However, CPI inflation there is still low by global standards (probably around 1.5%) and is likely to improve (or be well-contained) as the global economic slowdown limits further commodity price inflation.
- With inflation at least well-contained and the economy sluggish, the Bank of Japan should stay on hold for the foreseeable future.
- With the economy slowing further and the Bank of Japan likely on hold, there should be little upward pressure on the yen as a baseline case. However, the re-emergence of extreme softness and lower bond yields in the United States later this year could result in the yen appreciating some near the end of 2008.

CHINA TO REMAIN RELATIVELY ROBUST OVER THE REMAINDER OF 2008

We expect that, despite natural disasters, softer global growth, and past monetary tightening, China's economy will continue to grow robustly for the remainder of 2008. Contributing to the growth are factors such as:

- While economic slowdown in China is already apparent, growth there is still quite robust, running at about a 10% year-over-year pace. The sources of the modest slowdown are a deterioration of export growth due to a softer global economy, less vibrant business investment due to less robust profits growth, and food inflation, adversely impacting consumer demand. These factors should continue to cause China's economy to slow further over the remainder of 2008, but growth there should come in at about a still-robust 9-10% pace this year.
- As mentioned earlier, inflation year-on-year in China has already started to moderate, the result of less food inflation year-on-year from: 1) reaching the anniversary of last year's sharp run-up in food prices and 2) government incentives, such as pig "health insurance," resulting in greater pork supplies coming to market. As a result, inflation should continue to moderate in China over the remainder of the year, despite the fact that the government is now allowing retail fuel prices to rise.
- Despite our expectation for inflation moderating, we still look for the People's Bank of China to continue raising bank reserve requirements as insurance against inflation remaining high or unexpectedly moving higher.
- Finally, we expect a further, measured appreciation of the Chinese yuan against the U.S. dollar, with the government managing the rate of appreciation and using it as a tool to assuage pressures from trade partners, to rein in still-robust economic growth, and to contain inflation.

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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.

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