

# QUARTERLY MARKET AND ECONOMIC COMMENTARY NOVEMBER 3, 2008

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## **Q3 2008: THE GLOBAL MARKET MELTDOWN AFFECTS THE ECONOMY**

A widespread financial crisis and an economic recession hit the United States and other countries in the third quarter as credit markets froze, equity markets melted down, economic growth turned negative, and the government began to take unprecedented steps to rescue and fundamentally alter the financial services industry. At one point, as yields on short-term U.S. Treasuries fell to nearly zero and commercial debt yields rose, the spread between the two (commonly about 50 basis points) increased to nearly 500 basis points. Spreads on long-term Treasury bonds and corporate bonds showed a similar pattern. At the end of the quarter, U.S. stocks were down nearly 20% for the year and international stocks were down nearly 30%.<sup>\*</sup> According to the initial estimate, the U.S. economy experienced slightly negative growth (-0.3% annualized) in Q3 and other developed economies were expected to fall as well. Inflation in developed countries rose to the highest rates (over 5% on an annual basis) in many years.

<sup>\*</sup> As measured by the S&P 500® Index and the MSCI EAFE Index®.

Spreads narrowed slightly after the end of the quarter as the deep credit freeze began to thaw. However, the economic outlook for Q4 and for 2009 is far from rosy. The U.S. economy is entering a recession triggered by the effects of the housing market meltdown on the financial system and the real economy. U.S. GDP will continue falling in Q4 and through most or all of 2009, and unemployment, which rose to over 6% in October, is likely to climb higher in 2009. Stocks around the world fell another 14% in October and average corporate profits and earnings, which have been in negative territory for all of 2008, also continued to drop. This trend in corporate earnings should continue through 2009. Inflation, now largely impacted by declining commodity prices, should begin to fall into 2009 as the outlook shifts to concerns about prospects for a deflationary spiral.

### **THE FINANCIAL SYSTEM MELTDOWN**

Earlier, in March, as subprime home mortgage defaults rose and investors discovered some of the hidden risks in mortgage-backed securities, the United States Treasury and the Fed forced the sale of Bear Stearns, Wall Street's smallest major investment bank, to JP Morgan Chase, one of the world's largest commercial banks. This event was a harbinger of a widespread financial crisis that came to a head in Q3.

The underlying problem was the large number of mortgage-backed securities (MBS) held by banks—especially investment banks—around the world. Taking advantage of the very low, short-term interest rates prevailing earlier in the decade, investment banks, as well as Fannie Mae and Freddie Mac, borrowed huge sums in order to purchase and combine thousands of mortgages into MBS, shares of which were typically sold to investors or retained by the bank. This freed up commercial banks and other mortgage lenders to make more loans, stimulating housing prices, and eventually extending lending to subprime borrowers unqualified for prime mortgages. Then, starting in 2003, the Fed began to raise interest rates and, by 2006, home prices began to erode. Subprime homeowners began to default on mortgages, which affected a wide range of MBS that mixed subprime with prime loans.

By 2007, investors recognized that a relatively modest proportion of all U.S. mortgages were in default, but the

uncertainty about which MBS contained defaulting mortgages tainted the entire asset class. Investors grew unwilling to purchase MBS, then unwilling to loan funds to any institution that might be holding these securities. Because they borrowed at short-term rates 30 times or more than their capital base to buy mortgages, some investment banks, Fannie Mae and Freddie Mac, became effectively insolvent. The infection also spread to other short-term credit markets, such as credit cards, and auto loans, and the financial system began to seize up. It also invaded the real economy as consumers and businesses cut spending.

These problems, which developed over a span of years, accelerated dramatically in the month of September with news of bankruptcies, failures and rescues of some of Wall Street's oldest and most influential companies.

### **U.S. POLICY RESPONSE**

On September 7, the United States government took control of the mortgage giants Fannie Mae and Freddie Mac. A week later, Bank of America agreed to buy the faltering investment bank Merrill Lynch. The next day, after purchase negotiations with Bank of America and Barclays failed, Lehman Brothers filed for the largest bankruptcy in United States history, at \$639 billion. (Barclays purchased most of Lehman's operational units.) The day after that, on September 16, the government announced an \$85 billion emergency loan to rescue insurance giant AIG in exchange for an 80% equity stake in the company.

A few days later, the Bush Administration, at the urging of Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson, announced a rescue plan to confront the crisis. Then, on September 21, Goldman Sachs and Morgan Stanley abandoned the more loosely regulated investment banking model and announced their conversion to the greater protections (and oversight) offered by commercial banking regulation. Four days later, Washington Mutual collapsed, making it the largest thrift bank failure to date with \$307 billion in assets. JP Morgan Chase agreed to buy the company's banking operations. On September 29, the bank regulator FDIC helped broker a deal allowing Citigroup to acquire Wachovia's banking operations (this deal fell through shortly after quarter's end when Wells Fargo stepped in with a purchase offer that did

not require government assistance). Elsewhere that day, several banks in the United Kingdom and Europe were nationalized or infused with cash from their respective governments to keep them afloat.

On the same day, despite the warnings issued by Bernanke and Paulson, the House of Representatives rejected a proposed \$700 billion rescue package for financial firms and mortgage lenders. The equity market responded negatively, with a staggering 778 point drop in the Dow Jones Industrial Index. Demand for short-term U.S. Treasuries skyrocketed, driving real yields into negative territory. In contrast, demand for municipal and corporate bonds, especially very short-term debt, took a deep nosedive, as investors were unwilling to purchase some of these securities at almost any price.

### EFFECTS ON THE REAL ECONOMY

The loss of confidence in financial institutions and in the markets as well as in the government's ability to quickly rectify the problem solidified a freeze in the already chilled credit markets. With credit virtually unavailable, companies could no longer rely on short-term credit to maintain inventories, meet payroll and manage other expenses. And consumers, who had fueled their spending with housing and consumer credit, were less able to make purchases.

Real economies all over the world began to be affected, as the credit freeze accelerated and deepened an economic slowing cycle. In Q3, individual worker earnings, which have been relatively flat in most developed countries and negative in the United States since 2000, turned notably negative. In the United States, unemployment climbed to 6.1% in September and nonfarm job losses reached 159,000 for the month and nearly 300,000 for all of Q3. Initial estimates of real GDP fell 0.03% on an annualized basis in the quarter, significantly below Q2's positive 2.8% (bolstered by tax rebates). Personal consumption, which accounts for 70% of the U.S. economy, fell by 3.1%, the first decline since 1990. Other macroeconomic news was also negative, as a leading index of home prices fell by nearly 17% through the first nine months of the year and housing starts were down over 55%. Private investment dropped by 2% and durable goods spending (autos, large appliances, etc.) was reduced by 14%. Consumer confidence survey results dropped at an unprecedented rate.

In Europe, U.K. GDP fell 0.5% on an annualized basis and the Eurozone countries were, on average, expected to follow suit. Japan's economy, which has consistently trailed those of other developed nations, is also expected to be at or near zero growth. Developing countries, many of which have enjoyed growth rates far above the developed countries' *expected* long-term 3% rate, also experienced declining growth rates. China's economy, for example, cooled off to 9%, compared to its previous 10% annual growth and could struggle to keep growth above 7% in the near future as demand declines from developed countries for China's exports. Russia is also beginning to be affected by declining energy revenues, which have provided the foundation for its robust economy over the last several years. India's and Brazil's economies are also seeing the effects of the global slowdown.

### MARKET DECLINES IN THE THIRD QUARTER

Amid volatile market conditions fueled by a deepening credit crisis and signs of a weakening economy, U.S. stocks fell sharply in the third quarter of 2008. The Russell 3000<sup>®</sup> Index, which measures the broad U.S. stock market, declined 8.73%. Mid-cap stocks fared worst, dropping 12.91%, while large caps fell 9.35%. Small caps held up much better, dipping just 1.11%. Value stocks were down 5.26% but weathered the quarter somewhat better than growth stocks, which declined 11.93%. Across all categories of U.S. stocks, small-cap value—up 4.96%—was the only positive performer for the quarter. (All capitalization-size and investment-style stock returns are based on Russell indexes.) As of September 30, 2008, the Russell 3000 Index was down 18.81% year-to-date. Foreign stocks also posted poor results in the third quarter. The MSCI EAFE Index<sup>®</sup>, which measures stock performance in 21 developed nations outside North America, tumbled 13.02% in terms of local currencies and over 20% in terms of the U.S. dollar; in dollar terms. In particular, financial services and durable goods stocks were particularly hard hit throughout the world. Developing country stocks were even harder hit, as China led the way down.

The credit crisis and the upheaval among financial service companies led the broad U.S. bond market lower in the third quarter. The Lehman Brothers U.S. Aggregate Index, which reflects the performance of the domestic investment-

grade, fixed-rate bond market, was down 0.49% for the three-month period. Investors fled to the quality of U.S. Treasuries, pushing down yields and raising bond prices. The Treasury sector of the Lehman index rose 2.30%. At the same time, investors demanded higher yields from corporate bonds because of concerns about risk. That pushed corporate bond prices lower, and the corporate sector of the Lehman fell 7.80%. The yield on 10-year Treasury notes—a benchmark for many long-term interest rates—dropped slightly to 3.85% at the end of the third quarter, from 3.99% at the end of the second quarter. Year-to-date through September 30, the Lehman aggregate index returned 0.63%.

### THE DECLINING OUTLOOK FOR 2008

After the end of Q3, dramatic policy moves in the United States and other countries continued as credit and equity markets failed to calm down. Congress passed a modified financial services rescue package, developed countries' finance ministers coordinated a set of short-term interest rate cuts, the United States unveiled a \$250 billion plan to take ownership positions in large and small banks and, almost immediately, became the largest single shareholder in 12 of the nation's leading banks. The Treasury is also expected to take partial ownership of a wide range of regional and local banks. Further, plans were started to purchase distressed asset-backed securities in order to get them off the balance sheets of financial institutions. Plans were also made to modify distressed individual mortgages

in order to give relief to homeowners. One challenge for the federal government in all of these efforts is that its choices will have the consequence of effectively picking or anointing winners and losers in the financial meltdown.

On October 29, the Fed cut interest rates again down to 1.0%, the lowest level in four years. The hope was that very low short-term Treasury rates would encourage private firms and individuals to begin lending again. Also, in October, short-term spreads between Treasury and corporate yields began to narrow, an indicator that the credit freeze may be starting to melt.

Corporate earnings growth, the engine of equity market valuation, is likely to remain in negative territory through the end of 2008.

The current consensus forecast among macroeconomists is for overall economic growth (GDP) in the United States of approximately 1.8% for 2008, less than that for the Eurozone, and about 2.9% for the global economy (due to much higher growth rates among many developing countries).

Because the financial crisis is bleeding into the real economy, we are calling for somewhat lower growth rates, between 1.0% and 1.5% in the United States for 2008, about 0.5% in the Eurozone, and about 2.7% for the global economy. These figures are well below long-term expected national and global growth rates.

INDICATOR	2008 Q4 ESTIMATED	2007 ACTUAL	2008 FORECAST
GDP—U.S.	0.0%	2.0%	1.3%
GDP—Global	2.3%	3.9%	2.7%
GDP—Eurozone	0.7%	2.6%	0.5%
Crude Oil	\$65	\$72	\$65
CPI	3.0%	2.9%	4.0%
PCE	0.4%	2.8%	1.0%
10 Treasury	3.60%	4.63%	3.60%
Unemployment Rate	6.4%	4.6%	6.4%
Fed Funds	1.0%	4.25%	1.0%
\$US/Euro	\$1.48	\$1.46	\$1.48
Yen/\$US	105	112	105

## ON INTO 2009

When will financial markets recover? In “normal” times, economic forecasts and market projections are based on analyses of trends, tempered by experience. But these are far from normal times. Problems in financial markets are not isolated and are deeply affecting the real economy: production and purchase of goods and services. Further, in “normal” times, government action (and inaction) can affect financial markets through interest rates, spending and regulation. In these less than normal times, the role of government has become, and will continue to be, critical. Government has already begun to assume responsibilities not matched since the Great Depression. And the current crisis points to the need for a national discussion of the appropriate way to organize oversight of the new global megabanks, capital flows, and other emerging features of the world financial system. Above all, the government will need to consider how to preserve financial innovation while organizing appropriate mechanisms for systemic risk management.

Recent events have significantly increased the probability of a major economic recession during 2009. Financial markets, especially equity and short-term credit markets, have a long way to go before they can be declared recovered.

Due to weak corporate earnings growth along with dismal economic news, it is likely that the fundamental underpinnings of an extended market rally will not be in place for some time, creating a somber outlook for 2009. The consensus forecast is for about 1.2% economic growth in the United States in 2009. In contrast, we expect the current credit squeeze and financial crisis to continue bleeding into the real economy in 2009, pushing U.S. GDP down to between negative 2.0% and 4.0%. The wide spread between the consensus forecast and our forecast is due to the unusual role of government in the current crisis. If governments act decisively and credit markets react fairly quickly over the next few months, the outlook could be less dismal. If markets remain relatively frozen, then the more negative expectation may dominate. Europe may follow a similar path in 2009, but near the bottom end of the range. Major developing countries, such as China, Brazil, and Argentina, are also experiencing reductions in economic growth as exports drop. China and India should remain relatively strong in 2009, with growth in the high single-digit range.

Crude oil and other energy prices have dropped by over half since their July peak (\$146 per barrel of oil). Because of the economic slowdown, we expect oil prices to end the year under \$70. In 2009, prices could remain volatile as OPEC adjusts production and inventories wax and wane. More generally, inflation globally and in the United States ratcheted up in the second quarter of 2008 but since has dropped. With a downturn in the global economy, falling commodity prices and wages will more than offset other price increases and inflation will moderate in 2009.

In response to the emerging global credit freeze and in concert with other central banks, the Fed lowered its Fed Funds target rate to 1.0% in October from 4.25% at the beginning of the year. Most Treasury yields were lower at the end of the third quarter as investors moved out of equities and corporate bonds and into the safety of United States government debt. Especially short-term corporate spreads widened dramatically in Q3 as investors lost faith in the extreme short end of the corporate yield curve.

After declining about 25% against a trade-weighted index of global currencies since 2002, the U.S. dollar strengthened a bit in 2008. The dollar began the year at \$1.58 versus the euro and should end the year closer to \$1.48.

## WHAT'S AN INVESTOR TO DO?

In these extraordinary times, the focus should be on public policy as much as on trends in financial fundamentals. The economy and the markets are looking to positive shocks from the U.S. government in the form of capital injections, mortgage workouts and moratoriums, monetary policy, fiscal stimulus, and regulatory reform. In a world where international financial flows have increased dramatically, investors should also keep an eye on public policies around the globe, including the potential for coordinated actions among countries.

And in any event, the right strategy for institutions as well as individuals is to reexamine the tried and true tenets of investing: a long-term investment plan that includes a diversified portfolio of stocks, bonds, alternative assets and, if available, “guaranteed” investments. Rather than attempting to rapidly reallocate in an effort to time the market, portfolio management should consist of careful

review and deliberate rebalancing. As always, investors should look to low-cost, style-consistent investment products with a long investment horizon. Finally, individuals should consider creating a retirement income “floor” that combines Social Security with a low-cost guaranteed

annuity that will never be depleted. With these simple precepts, investors can position themselves to limit the damage from market turmoil and take advantage of any future market upturns.

**APPENDIX  
 TIMELINE OF EVENTS AND RESULTING EFFECTS**

GOVERNMENT ACTION	MARKET IMPACT	UNINTENDED CONSEQUENCE
<b>September 7</b> Federal government takes control of Fannie Mae and Freddie Mac, the largest guarantors and securitizers of mortgage loans.	Stockholders in these two firms lose their investments.	Fannie and Freddie debt prices continue to fall and credit markets become less, not more, liquid.
<b>September 15</b> Lehman allowed to go bankrupt without intervention from the Federal government, operational units of the once-prestigious firm are sold to Barclays.	Investors shocked at government nonintervention.	Credit spreads blow out and equity markets take a steep nosedive
<b>September 16</b> Federal government injects \$130 billion into AIG including loans and equity positions.	Financial services stocks continue downward slide. Investors continue to move to short-term Treasuries.	Highlights the shakiness of the credit default swap market.
<b>September 29</b> Congress rejects U.S. Treasury’s proposed financial system rescue plan.	Massive deleveraging continues as money flows to short-term Treasuries. Stocks plummet.	Widespread loss of confidence in the U.S. government’s ability to solve the credit crisis. Fear of a major recession intensifies.
<b>October 2</b> Congress passes amended rescue plan focusing on Treasury purchase of distressed securities and other measures.	Temporary bounce in stock market, followed by recognition that distressed securities purchases will take months to implement.	Credit markets continue to freeze up. Volatility increases with massive intra- and inter-day swings in the market. Distinct evidence emerges of serious negative effects on the real economy.
<b>October 8</b> Central banks around the world cut interest rates in unison in their first broadly coordinated effort to curtail the growing credit crisis.	Stock markets soar in early trading, but gains fade in the final hour amid uncertainty about whether lower interest rates will avert recession.	Extremely wide credit spreads narrow less than expected.
<b>October 13</b> The U.S. government takes equity positions in 12 major banks, injecting capital into the institutions. Plans to take similar action in smaller banks around the country are announced.	Market gyrations continue. Short-term credit spreads show first sign of beginning to narrow.	Credit markets remain largely frozen, forcing institutions to sell liquid assets to raise cash.

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