

MARKET MONITOR

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HOW MUCH STIMULUS IS ENOUGH?

By now it is common knowledge that the United States is experiencing its worst recession since World War II thanks to the meltdown of lending and consumer spending. Investors are looking to the incoming President-elect Barack Obama Administration and Congress to provide a sharp policy focus and to allocate significant resources aimed at getting the economy back on track. In fact, there is a visible debate about the size of the stimulus needed to lower unemployment and bring economic growth back.

Key questions for investors to consider include:

- What will it take to get the economy moving again?
- When will the bad news end, or at least abate?
- How will markets behave during this period?



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The following table (Exhibit I), shows U.S. gross domestic product (GDP), which is the market value of all goods and services the economy produces, totaled a little less than \$14 trillion in 2007. With negative GDP in the third and fourth quarters, U.S. GDP could decline in real, inflation-adjusted terms by over 1% in 2008.

EXHIBIT I

U.S. GDP, Federal Outlays, Budget Deficit and National Debt: 2007–2008, Estimate for 2009

	2007	2008	2009	2009
			Scenario 1	Scenario 2
GDP (trillion \$)	13.7	14.4	14.5	14.3
GDP Real Growth	2.0%	-1.5%	-1.5%	-3.0%
Federal Outlays (FY trillion \$)	2.7	3.0	4.0	3.5
Outlays as a % of GDP	20%	21%	28%	24%
Federal Deficit (FY billion \$)	162	455	1000	800
Deficit as a % of GDP	1.2%	3.2%	6.9%	5.6%
National Debt (trillion \$)	9	10.5	12.6	12.2
National Debt as a % of GDP	66%	73%	87%	85%

Notes:

1. All figures are in current dollars except GDP real growth
2. GDP real growth assumes 2% inflation for 2009

Sources: U.S. Bureau of Economic Affairs, Congressional Budget Office, author's estimates (in red)

Federal spending and outlays represent a significant percentage of U.S. GDP, hovering in the high-teens and low-20s, as a percentage over the past several decades. In contrast, the difference between outlays and revenues in the federal budget deficit has fallen and risen substantially; it dropped to zero at the end of the 1990s. From 2007 to 2008, the deficit nearly tripled, representing over 3% of U.S. GDP (estimated) in 2008. Finally, the total U.S. national debt has ranged from over 90% just after World War II to about 33% in 1980. In 2008, the debt totaled about \$10.5 trillion, an estimated 73% of total U.S. GDP.

Now, let us examine the types and amounts of current and possible future federal fiscal stimuli. In calendar year 2008, the Federal Reserve pumped money into the economy by lowering short-term interest rates to all-time lows, creating unprecedented lending capabilities for banks and other financial institutions, and orchestrating other actions.

For example, over the last six months a basic measure of the U.S. money supply (“M2”) expanded by about 6.5% (about 13% on an annual basis). In federal fiscal year 2009, which began in October 2008, the Bush Administration announced a plan to spend about \$700 billion to combat the escalating financial crisis. This plan eventually encompassed investments in distressed securities, financial services companies, and the auto industry. The intention was to increase liquidity so that lenders would begin lending again and consumers would continue spending, thus helping the financial system and more generally providing economic stimuli.

GOVERNMENT ACTIONS KEY IN SUPPORTING RECOVERY

President-elect Obama has already called on Congress to provide additional economic stimulus in the form of legislation that will be waiting on his desk when he takes office on January 20. Although estimates of the amount vary and action by the new Congress is by no means certain, it is possible that the bill will include up to \$700 billion in short-term and long-term spending. The plan is expected to include tax cuts for the middle class, as well as help for distressed homeowners and unemployed workers. It is also expected to include spending on infrastructure projects throughout the nation. In light of current oil prices, it is not certain how much support there will be for clean energy development. In any event, the current fiscal year could see a total federal stimulus package of \$1 trillion or more on top of the baseline federal budget of around \$3 trillion. If so, the macroeconomic multiplier effect could be in the range of \$1.5 to \$2.5 trillion as the initial stimulus cascades through the economy.

Will these actions be enough to get the economy growing and the markets moving upward? No one can be certain of their success. In the above exhibit, *Scenario 1* reflects a more optimistic view. The optimists, who are a considerable group, generally believe that the stimuli will forestall a year-long decline as the economy will continue to contract in the first half of 2009, and then begin to grow modestly after that time. Markets are expected to behave similarly or even anticipate the economic recovery, and unemployment will lag the recovery. In this view, 2010 will usher in renewed robust growth.

There are a couple of major problems with this view. First, Congress and perhaps even the new administration may not have the collective stomach for the deficits implied by stimuli (spending and tax cut) projections. As *Scenario 1* shows, a major stimulus package could increase the annual deficit and total national debt-to-GDP ratios to rates not seen since just after World War II. Opposition to significant stimulus could come from those who believe that it will lead to a version of stagflation (rising inflation and unemployment) or that, regardless of the effects, government should not intervene so massively in the economy.¹ If so, the federal government may hold back and implement a more modest stimulus package along the lines shown in the less optimistic *Scenario 2*. If so, deficit and debt ratios will still rise significantly, but the economy may contract throughout the year rather than experience a partial recovery.

Second, *Scenario 1* illustrated above may not work. Even with a major stimulus package, the economy might not react positively until late in 2009 or the beginning of 2010 as consumers and businesses fail to respond as anticipated. In other words, government spending and tax cuts, no matter how big, may by themselves not be enough. If they don't create a psychology of safety on the part of consumers and businesses, then the stimulus may not work because they will continue to hoard cash. Or, other possible new federal and international policies intended to reign in financial services companies and financial practices could delay recovery, even if their effects are, on balance, positive in the long run. In either case, we could see an economic contraction in 2009 on the order of -3% as in *Scenario 2*.

All this implies that the federal government, including the administration, Congress, and the Fed, should all be prepared not only to act, but also to monitor carefully economic indicators and be prepared to act again if necessary, and to sell the stimulus package as a positive solution. Under any scenario, deficits and debt will climb to new heights so artificial ceilings should be avoided.

¹ In contrast, some economists are arguing that when interest rates are so low that households and businesses are tempted to hoard cash, government spending is basically costless. E.g., Paul Krugman, "Optimal Fiscal Policy in a Liquidity Trap." Working paper, December 29, 2008.

INVESTORS WILL CONTINUE TO SEEK SAFETY IN FIRST HALF OF 2009

In these circumstances, what can investors expect from the major asset classes? The analysis presented here does not suggest that the foundation for a major stock rally will appear any time soon, despite the prospects for a major stimulus package. Another way to think about this is to consider the long line of companies and industries that have publicly lined up for a federal handout, as well as continued financial market difficulties. The possible extra spending and tax cuts could double the deficit-to-GDP ratio from about 3% to about 6%, but the question is whether that would be enough to create sufficient demand to offset the current and continuing decline in national consumption that is affecting housing prices and home sales, retail sales, and consumer durable sales. And, in any case, the financial services sector cannot yet see any light at the end of the tunnel.

On the fixed-income side, corporate yield spreads remain high, implying bargains in corporate bonds. But until investors stop holding tight to low-yield government bills and bonds, a sustained corporate bond rally may not appear. Investors are also deeply concerned about many alternative asset classes. For example, deleveraging and lack of transparency could continue to take a toll on hedge funds and other alternatives, and until global economies recover, commodities may continue to perform poorly.

With all of this, federal government action is critical, regardless of the short-term reaction of financial markets. In the long run, the federal government is the only actor now capable of pushing and pulling the economy into a healthier state. It is also the only national actor in a position to correct and prevent the kinds of excesses and oversights that led to the current crisis.

In normal times, investment strategists and investors pay limited attention to government. In current times, we need to pay careful and critical attention to what is coming out of Washington.

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