

MARKET MONITOR

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BRETT HAMMOND
CHIEF INVESTMENT
STRATEGIST

SECOND QUARTER MARKETS AND ECONOMIC OUTLOOK: GREEN SHOOTS AND LEAVES?

Depending on how you look at it, the U.S. and global outlook is either promising or discouraging. On the one hand, equity markets, commodities, and some corporate bonds have begun to recover from market lows; an index of U.S. leading indicators turned up; job losses began to abate; and consumer and business confidence improved. On the other hand, equity markets are still far below their peak, the global economy is expected to shrink in 2009, and many families' incomes continue to drop.

- Are we seeing the “green shoots” of an economic recovery or a continued season of drought and discontent?
- Are the financial markets poised for growth or disappointment?
- More generally, how will the Obama administration’s financial system reform proposals affect the economy and the markets?
- When will inflation rear its ugly head and what will that mean?

The short answer is that the economic and financial climate is anything but overheated. Green shoots will take much nurturing and a long time to grow and mature in this cool climate. Public policy, in the form of low interest rates, spending stimulus, and financial system support and reform, has and should continue to help, but is far from a quick panacea.



POSITIVES AND NEGATIVES

On the negative side, as of late June, broad equity market indexes were still about 40% below their November 2007 highs. Demand for an index of higher-rated (Aaa) bonds fell as yields rose about 100 basis points (bps) since the first of the year. Credit spreads (the difference between corporate bond yields and Treasury bond yields) were still well above where they have been for most of the decade, indicating that borrowing and lending is still chilly if not exactly frozen. Conditions for American workers deteriorated as real personal income fell for the ninth consecutive year, and job losses continued to rise. The index of leading economic indicators for industrial nations around the world continued to fall, as economic growth in Europe and Japan was expected to remain in significantly negative territory. And economic experts, as well as Washington and Wall Street pundits, expressed concern about incipient inflation and the returns on inflation-linked bonds began to rise.

In a more positive vein, between March 9 and June 10, 2009, the S&P 500® rose a breathtaking 40%, while some emerging market stock indexes climbed even earlier and faster. Since the end of 2008, U.S. Treasury bond yields (with the exception of TIPS), which move inversely to prices, rose about 100 bps, as investors began to sell Treasuries and move into riskier securities. Riskier, lower-rated (Baa) U.S. corporate bonds benefited from the move out of Treasuries as their prices rose and yields fell,¹ and corporate bond issuance showed signs of a revival. U.S. economic growth (GDP) could begin to grow in the latter half of 2009, and China's GDP, which fell from double digits in 2008, is expected to grow about 7.5% in 2009. In the U.S., the Conference Board's Index of Leading Economic Indicators, which often foreshadow future growth, rose more than 1% in April and May (2009), the biggest back-to-back gain since the end of 2001.

GLOBAL ECONOMY

The global economy is still suffering from the financial crisis that froze credit, reduced consumption, eliminated jobs, strained financial institutions to the breaking point, caused them to sell liquid assets, and pushed declining but still relatively positive economic growth into negative territory.

¹ Moody's Baa corporate bond yields fell by about 200 basis points from November 2008 to June of 2009.

Reflecting this crisis, the U.S. GDP contracted at an annual rate of 6.3% in the fourth quarter of 2008 (4Q 2008) and another 5.5% in the first quarter of 2009 (1Q 2009). We expected GDP to decrease at a rate of about 1% in Q2 2009 and the U.S. and global economies to fall 3% overall in 2009—the worst such performance since the end of World War II. Compared to potential GDP growth of about 3% per year in the U.S., Europe and Japan, and about 5% globally, there is a huge, multitrillion dollar gap between actual and potential economic growth.

Recognizing that the consumer and business sectors are hurting and unlikely by themselves to turn around the global recession, governments around the world have reacted with differing combinations of fiscal and monetary stimulus. China led the way with government spending and controls designed to increase demand and provide jobs. The U.S. and the U.K. have offered significant fiscal and monetary stimulus as well as direct aid to ailing financial institutions, state governments and individual homeowners, among others. In the U.S., federal government spending stimulus totaled about \$800 billion plus, with a focus on aid to state and local governments and individuals; investments in infrastructure, healthcare, and research; and tax cuts.

For its part, Federal Reserve policy is still stimulative. The Fed showed little inclination to raise its overnight bank lending rate (Fed Funds rate), which is still close to zero. In addition, as of mid-June, the Fed held a little over \$2 trillion on its balance sheet, including about \$450 million in mortgage-related securities and \$633 million in U.S. Treasuries. These figures represent significant increases compared to 2007 and, along with quantitative easing, reflected the Fed's efforts to promote monetary stimulus and financial stability.

The positive impact of all these policies are being felt, first, through monetary policy, then tax cuts, and spending. As of June, indicators were noticeably mixed. Some, such as stock prices, the Conference Board's Leading Economic Indicators, consumer confidence, personal saving and commodity prices, had risen. Some significant indicators were still falling, such as corporate profits, housing prices and consumer spending. Some, such as retail sales, new home starts and inflation, began to level off but have yet to show a marked increase.

This kind of mixed news and uncertainty is to be expected when the economy and the markets are struggling to turn around. What can we expect from the economy over the next 18 months or more? The U.S. economy, after falling 3% this year, is likely to enter positive territory but experience subpar growth of about 1.5% in 2010. In addition, job losses will gradually abate, and unemployment will peak in 2010 at about 11% nationally, but much higher in states such as Rhode Island, Michigan, California, and South Carolina. Overseas, we expect that recovery in Europe, the U.K., and Japan, will trail China, India, and other leading developing nations. Consequently, world trade and capital flows are likely to remain depressed for some time. Several factors lie behind these modest expectations.

First, the U.S. appears to be caught in something akin to a liquidity trap (where near-zero interest rates fail to stimulate more spending and savings increase). Although the Fed reduced short-term interest rates to some of the lowest on record and the money supply and the Fed's balance sheet expanded dramatically last year, from the beginning of 2009 through May the household savings rate increased from negative territory to nearly 7%. Increased savings is a good sign for the nation's long-term future, but it can limit any recovery in the short run.

In addition, short-term commercial loans (commercial paper) declined by half a trillion dollars from the beginning of this year through May and private financial institutions continue to hoard cash. Banks' liquid assets (cash = \$1 trillion; Treasury and agency securities = \$1.25 trillion) reached about a quarter of all bank assets in June—the highest percentage since 1999—while depository institutions increased their deposits at the Fed from \$32 billion to about \$750 billion from September 2008 to June 2009.

Second, one of the major tools to break out of a liquidity trap is government spending, but U.S. federal fiscal stimulus will be slow in coming, with the bulk of the spending to occur in 2010 and 2011. This leaves the economy waiting for several more months before it will feel the positive effects of increased federal spending.

Third, the U.S. depends on other countries to purchase its goods, services and national debt. To put dollars into the hands of foreigners interested in funding our debt, the

U.S. must be in a position to pay for imported goods and services. Although the U.S. current account (payments received from abroad minus payments made to entities located abroad, not including capital investments) are improving (becoming less negative), the U.S. is both importing less and exporting less as economies around the world have faltered. As imports and exports recover, this can assist both U.S. debt finance as well as the U.S. economy.

SHORTER-TERM FINANCIAL SYSTEM SUPPORT

Besides providing monetary and fiscal stimulus, governments around the world have been shoring up banks and other financial institutions through loans and equity positions in both large and small institutions. The purpose was to support institutions that were “too big to fail” (i.e., whose failure could deeply affect the rest of the financial system) and to encourage banks to begin lending again. In the U.S. actions included effectively “nationalizing” Fannie Mae and Freddie Mac, the two largest purchasers and packagers of home mortgages, and taking significant ownership positions in a wide variety of private-sector financial institutions. As of mid-June, at least nine major banks were paying back investments made by the federal government through the TARP (Troubled Asset Relief Program), rather than using it to provide private-sector liquidity.

Two other federal financial support programs also began to be implemented. The U.S. Treasury, the Fed and the FDIC plan to provide approximately \$1.5 trillion in financial sector investment and support. The TALF (Term Asset-Backed Securities Lending Facility) and the PPIP (Public-Private Investment Program) were designed to provide incentives for financial institutions to create new consumer-related debt (credit cards, auto loans, and other types of loans) as well as to stimulate purchases of distressed assets. The effects of these programs on the stability of financial institutions and on asset-backed securities pricing are more likely to be visible in the latter half of 2009 and beyond.

Similarly, there have been efforts by a number of federal agencies to assist owners whose mortgages are in default or underwater,” or whose incomes have declined. Again, these efforts could bear fruit, but it is likely to take until next year to begin to see widespread positive effects.

LONGER-TERM FINANCIAL SYSTEM REFORM

The financial system crisis reflected, among other factors, a recurring condition in which the evolution of the financial system outpaces that of the oversight system meant to watch over it. In the current case, the emergence and growth of global financial firms and new, lightly regulated credit instruments (e.g., credit default swaps, asset backed securities) challenged U.S. and foreign regulators, who had limited authority to respond comprehensively. In June 2009, the Obama administration introduced legislation designed to prevent reoccurrence of the current financial crisis. Taken together, the reform proposals reflected a moderate, centrist approach, rather than a revolutionary restructuring of national and international oversight authority. Some significant elements of the legislation include the following:

- **Increase responsibility of the Fed for systemic risk regulation.** Along with its responsibility for limiting unemployment and inflation, the Fed would exercise oversight of risks that could endanger the financial system. Note that, over the past year, the Fed has stepped in to counter such systemic risks on a number of occasions.
- **Create a Consumer Finance Protection Agency** designed to be a watchdog for consumer credit, including credit cards and auto loans and other loans, somewhat along the lines of a Consumer Product Safety Commission.
- **Combine regulation of nationally chartered banks into one agency.** Currently nationally chartered bank oversight is split between several agencies.
- **Create a national insurance oversight capability for the first time.** Currently insurance regulation is up to the states.
- **Increase oversight of hedge funds, asset-backed securities and credit default swaps,** most of which have been unregulated or lightly regulated until now. Hedge funds, for example, would be required to register with the SEC, and credit default swaps would be traded on open exchanges. Certain critical issues, most visibly the credit rating agencies' structural conflict of interest, were left largely unaddressed.

It is by no means certain what portions of the legislation will pass as proposed. For example, opponents have heavily criticized the consumer watchdog agency proposal and the increase in the Fed's authority. In addition, the ability of these proposals, if enacted, to prevent future crises is uncertain, especially crises involving international capital flows. For example, although the U.S. savings rate has only recently risen above zero, other countries' savings (e.g., China's household savings rate, which is 40%) continue to fuel an excess of global savings looking for investment opportunities. On top of national efforts, international coordination and oversight are needed to respond to the growth of financial institutions and capital flows that cross national boundaries. However, the current proposals are intended to address a number of important issues that require immediate attention.

IMPLICATIONS: INFLATION AND MARKET RALLIES

Inflation. As the first half of 2009 ended, the magnitude of government stimulus and the potential for economic recovery prompted renewed fears of inflation. For example, a nearly trebling of oil prices and rises in the prices of other commodities seemed to foreshadow what could happen as the global economy improves and demand increases.

However, based on our analysis, inflation shouldn't be a concern for the next three to four years. There are several reasons for this conclusion. First, despite large budget deficits and massive expansion of the money supply in 2008 the prospect of deflation began to abate during 2Q 2009, over the past year the Consumer Price Index (CPI) fell by about 1%—the first such sustained drop in many years.

Second, with unemployment high and rising and slack factory production, there is little likelihood of wage or price inflation.

Third, commodity price increases may have more to do with short-term concerns such as hoarding and supply bottlenecks than with fundamental demand for these products.

And fourth, as we have seen, the U.S. and global economies are operating well under their long-term potential. Taken together, these factors suggest that we have a long way to go before excess demand begins to push up prices beyond the long-term average (3%) or the Fed's implicit target (2% or less).

Nevertheless, investors should watch for signs of inflation, the most important of which would be a failure by the Fed and other central banks around the world to raise interest rates and rein in the money supply or a failure by governments to moderate deficit spending even if the economy improves significantly. A robust economy, with falling unemployment, high rates of production and increased demand, will require a different monetary and fiscal regimen than the one in place now.

Market Rallies. A question of more immediate concern is the sustainability of the 2Q 2009 equity market rally. Market rallies are often the harbingers of better economic times ahead. In fact, equities are often considered to be, and are, leading economic indicators as investors buy equities in anticipation of future company earnings growth. Therefore, it is not initially surprising that the spectacular increase in equity market index prices in the U.S. and some other countries was not accompanied by a commensurate increase in corporate profits and earnings.

However, overall corporate earnings are still falling and are expected to do so through the rest of this year, so the ratio of price to future earnings has risen dramatically in the past few months. In other words, the fundamental underpinnings of a sustained market rally are not yet in place, since we can't expect increased earnings in the immediate future. Nevertheless, accounting write-offs by companies in the S&P 500® dropped dramatically in 1Q 2009 after topping out in 4Q 2008. We expect that trend to continue, as it did near the end of previous bear markets, possibly setting the stage for better corporate earnings at the beginning of 2010.

Several industries bucked the general downward trend in earnings, including brewers, computer hardware, IT consulting and other services, gold and household products. Other industries experienced record earnings growth reductions, including automobile and motorcycle manufacturers, construction-related industries, consumer electronics and hypermarkets.

WHAT'S AN INVESTOR TO DO?

Based on what has happened and what we expect to happen, investors should avoid market timing since no one can accurately predict when markets will turn up or down. This means reassessing risk tolerance in light of the current market and economic conditions and preparing for a future market rebound by taking concerted, but modest steps to increase holdings of riskier assets.

Similarly, developing and maintaining a diversified portfolio is critical in order to avoid placing all an investor's eggs in one basket. In so doing, there are some asset classes that appear more attractive than others and shouldn't be avoided. Examples include higher-rated corporate bonds, which have been bypassed in the rush for equities and lower-rated corporate bonds; municipal bonds, which were beaten down before the federal stimulus package began to direct spending towards the states; and some alternative assets, such as private equity, which likewise were avoided by many investors due to their illiquidity and the uncertainties surrounding the economic meltdown.

Some other asset classes look less promising. U.S. Treasury prices have been dropping and appear to be unlikely to sustain a major rally in the near future, unless the economy fails to improve. Stock prices could rise next year, but they are more likely to remain volatile and move sideways until the prospects for improved corporate earnings are closer at hand.

Within equities, emerging market stocks will remain especially volatile but could see continued improvements as investors respond to economic growth. In addition, depending on the prospects for healthcare reform, healthcare, IT consulting and computer hardware could present attractive opportunities.

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Brett Hammond is available to comment on economic data. If you wish to speak with him, please contact Chad Peterson, Media Relations, 212 916-4808 or email cpeterson@tiaa-cref.org.

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