

MARKET MONITOR THIRD QUARTER REVIEW

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AS THE GREAT RECESSION COMES TO AN END, WHAT TO LOOK FOR

In the third quarter of 2009, the recession that had gripped the U.S. and global economies since the end of 2007 most likely came to an end. Anticipating possible economic growth and corporate profits to come, most major investment markets continued a furious rally that had begun at the end of the first quarter. Based largely on federal fiscal and monetary stimuli, the market and economic outlook for the end of 2009 and into 2010, while still fragile, grew increasingly positive. Things to look for include a slow economic recovery, further decline in the U.S. dollar, the absence of inflation, and areas where growing valuations could signal the need for caution in selected asset classes.

INVESTMENT MARKETS

The performance of financial markets has been, to say the least, remarkable. Since hitting bottom on March 9, 2009, broad equity indexes experienced their best two-quarter performance since the Great Depression, with the S&P 500 and the Russell 3000 up about 16% in the third quarter alone. Third-quarter midcap and small-cap index performances were even more robust, with the Russell Midcap Index returning 20.62% and the Russell 2000 Index returning 19.28%. Investors also rediscovered value stocks. The Russell 3000 Value Index, a broad index of value stocks, significantly lagged the Russell 3000 Growth Index in the first two quarters, but outperformed the broad growth stock index by nearly 4.5 percentage points in the third quarter. Nevertheless, reflecting the 55%-plus decline in the U.S. stock market that began in October 2007, all major U.S. equity indexes remained negative for the 12 months ending in September 2009.

Except in Japan, equity indexes around the world did even better than in the U.S. Reflecting positive economic news coming out of China, Germany and other countries, MSCI Europe, MSCI Pacific ex Japan, MSCI EAFE Small and MSCI Emerging Market stock indexes all rose more than 20% in U.S. dollar terms during the third quarter. Unlike the U.S. indexes, all foreign MSCI stock indexes (again with the exception of Japan) had positive returns for the 12 months ending in September 2009.

QUARTERLY MARKET MONITOR THIRD QUARTER COMMENTARY

The fixed income markets also posted gains during the third quarter, though the news was more mixed than in the equity markets. The Barclays Capital U.S. Aggregate Bond Index, which includes U.S. Treasuries as well as a wide variety of corporate bonds, returned 3.74% for the third quarter and was up nearly 5.75% for first three quarters. Corporate bonds, particularly high-yield bonds, were the big performers. The Barclays Capital U.S. Credit Index rose 7.47% for the quarter and the High-Yield Bond Index returned 14.22%. In contrast, the U.S. Government Index returned a little over 2% during the third quarter and was down 1.25% for the first three quarters. These results reflect a transition from 2008, when investors generally shunned corporate bonds and credit markets in favor of government securities. This year, recognizing that prices had dropped as yield spreads skyrocketed, investors returned enthusiastically to credit securities. The exception was U.S. inflation-linked bonds, or TIPS (Treasury Inflation Protected Securities), which had negative returns in 2008 due to investor fears about deflation. In 2009, through the end of September, investor concerns focused more on the prospects for inflation than deflation, and TIPS outpaced other government bonds, returning nearly 9.5%.

Amid all the positive investment news, special mention should be made of commercial real estate. FTSE NAREIT Equity REITs, a broad index of the stock prices of real estate investment trusts, rose 33.28% during the third quarter and about 17% for the first three quarters of 2009. In contrast, for the 12 months ending in September, REITs fell 28.40%. Moreover, direct real estate – direct ownership of office, retail, industrial and multifamily rental buildings – is still going through its first significant downturn since the late 1980s and early 1990s. Vacancy rates are up, especially in the retail area, and building values have dropped.

THE ECONOMY

REITs, like stocks in other sectors, tend to anticipate future economic and profit growth as well as other economic news. The critical question now facing investors is whether corporate earnings and the economy will rise enough to justify the market gains that have already occurred. Many companies have cut costs severely so that any future sales increases are likely to affect corporate earnings positively and immediately. Good sales and macroeconomic news during the fourth quarter of 2009 could provide favorable

U.S. EQUITY MARKET TOTAL RETURNS

	QTD AS OF 9/30/09	1 YEAR AS OF 9/30/09
Russell 3000® Index	16.31%	-6.42%
Russell 3000® Growth Index	14.12%	-2.19%
Russell 3000® Value Index	18.59%	-10.79%
Russell 1000® Index	16.07%	-6.14%
Russell Midcap® Index	20.62%	-3.55%
Russell 2000® Index	19.28%	-9.55%

OTHER DOMESTIC EQUITY MARKET INDEXES

S&P 500	15.61%	-6.91%
Dow Jones Industrial Average	15.82%	-7.38%
Nasdaq Composite	15.91%	2.53%
FTSE NAREIT Equity REITs	33.28%	-28.40%

GLOBAL EQUITY MARKET TOTAL RETURNS MSCI INDEXES*

USA	15.41%	-7.47%
Europe	22.92%	1.57%
Pacific ex Japan	27.38%	23.19%
EAFE Small	22.13%	15.46%
EAFE	19.47%	3.23%
Japan	6.51%	-0.57%
Emerging Markets	20.91%	19.07%

*Returns are in U.S. dollar terms.

FIXED INCOME MARKET TOTAL RETURNS BARCLAYS CAPITAL INDEXES

U.S. Aggregate	3.74%	10.56%
U.S. Government	2.03%	6.74%
U.S. Credit	7.47%	19.49%
U.S. Corporate High Yield	14.22%	22.34%
Municipal Bond 10-Year	6.60%	14.30%
U.S. TIPS	3.08%	5.67%
Global Emerging Markets	12.16%	19.58%

tailwinds for further equity and corporate bond returns. In contrast, poor sales and corporate earnings news could quickly turn into headwinds for markets. On the inflation front, a significant uptick in consumer prices would justify previously strong TIPS returns and hurt other bond returns.

In the first and second quarters of 2009, U.S. GDP declined, respectively, about 6% and 0.7% on an annual basis, following a 5.4% drop in the fourth quarter of 2008. So far, the downturn could turn out to be the sharpest since 1946. However, there are some reasons to think that the recession, which is already the longest since the Great Depression, may be over. When the figures are announced,

QUARTERLY MARKET MONITOR THIRD QUARTER COMMENTARY

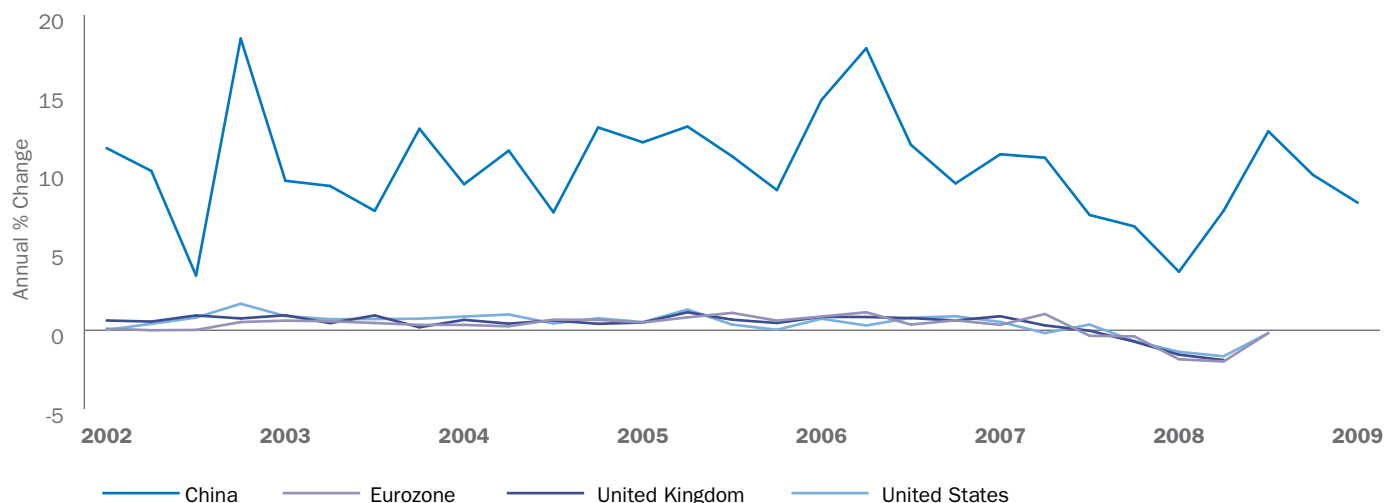
second half U.S. economic growth could turn out to be modestly positive – about 2.5% on an annual basis.

Among the positive signs, actual federal stimulus spending is just now beginning to have a significant effect on national consumption. In addition, housing starts and sales have improved, credit markets continue to thaw, deflation has abated, and retail sales have stopped declining. Among less positive signs, any recovery will be “jobless” for some time to come, housing prices continue to decline, troubled mortgage assistance is far from robust, regional banks continue to fail, the trade deficit has taken a jump, and corporate profits are likely to remain weak. The recent rise

in household savings – from zero to about 5% of income – would be good for long-term economic health. In the short run, however, any savings increase means a drop in consumption, which is the largest component of U.S. economic growth.

Significantly, the economic news from Europe and Asia – with the exception of Japan – is also positive. China’s and India’s economies have returned to double-digit growth rates after declining to about 5% annualized growth in late 2008. We now expect the German economy to decline about 5% this year, somewhat less than previously forecast.

GROSS DOMESTIC PRODUCT (GDP)



ECONOMIC AND MARKET OUTLOOK:

THINGS TO WATCH FOR

After an outright decline in 2009, the U.S. and global economies could experience positive growth in 2010 — 2.5% and 4% respectively. However, the economic outlook is uncertain and any number of disappointments could stymie or delay progress. Disappointing corporate profits, low-to-negative job growth, a geopolitical shock or a chill in the credit markets could dampen or even squash nascent economic growth.

In the near future, economic growth will be highly dependent on public policy. Monetary stimulus remains strong in the form of low interest rates and government securities purchases. Fiscal stimulus in the form of spending and tax cuts is also strong and likely to continue for another two years. In addition, government support

for the financial industry has been critical in preventing systemic collapse and in unfreezing lending. This is true, not just in the United States but also in China and other countries that have shown signs of significant recovery. The challenge around the world will be for governments to adjust monetary, fiscal and financial industry policy judiciously. Eventually, loans must be repaid, distressed securities resold, interest rates raised, and deficit spending reduced. Too soon or too little and there is danger of a return to recession. Too late or too much and there is danger of overstimulation and inflation. In either case, financial markets could suffer.

The U.S. dollar, however, could be volatile but a long-term downward trend in its value could continue. After peaking in 2002, the dollar’s value has generally declined, rising temporarily during the recession as investors sought

QUARTERLY MARKET MONITOR THIRD QUARTER COMMENTARY

the relative safety of U.S. Treasuries and other U.S. investments, but continuing to fall in recent months. Given investors' appetite for foreign assets, the current and projected U.S. federal budget deficits and relative economic growth rates around the world, the dollar could continue a

gradual decline for the foreseeable future. One implication of a falling dollar for investors is that foreign assets, other things being equal, receive an extra return boost due to currency effects.

THE VALUE OF THE DOLLAR



In contrast, conditions are such that inflation is likely to remain benign, largely due to limited wage pressure because of continuing high unemployment, limited price pressure due to the ability to shift production of many goods and services around the world, a long-term decline in the value of the dollar, and the relatively low economic growth expected for the next several years. Instead of general, across-the-board consumer price increases, investment markets are more likely to be characterized by asset bubbles, where a large pool of global savings available for investment, relatively low borrowing costs, and an uncertain outlook for long-term returns, could encourage investment fads such as those experienced in the past decade in dotcom or growth stocks, housing and financial stocks. Mitigating factors could include possible significant financial system reforms, which are now being considered

by Congress; agreements among leading nations, such as those discussed by the G-20 nations at their recent conference in Pittsburgh; and potential reluctance by investors to commit funds to risky investments.

Given this outlook, if U.S. TIPS, corporate bond and stock returns continue to rise, valuations will become stretched, and these broad asset classes will become less attractive, compared to other, less popular asset classes, such as commercial real estate and some other types of alternative asset classes that have not experienced similar gains. Such a situation underscores the wisdom of strategic diversification and asset allocation. Rather than chasing the currently hot asset class, investors may do well in the long run by adopting a long-term asset allocation and then rebalancing on a regular basis in response to changing market forces.

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