

WHICH WAY IS UP? 2010 MARKET AND ECONOMIC OUTLOOK

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SUMMARY

The year 2010 begins with a far more optimistic outlook than did the beginning of 2009. Then, the nation and the rest of the world were locked in the grip of the Great Recession: Global equity and credit securities markets were nearly in freefall, housing prices and sales in the United States and much of Europe were plummeting, many financial services firms were teetering on the edge of collapse, jobs were disappearing, consumers quit spending, and economic output was falling worldwide. Much of this news was more severe than at any time since the Great Depression.

At the beginning of 2010, things are looking up, but by how much? The Treasury yield curve is steeper, suggesting that investors anticipate future economic growth. After hitting bottom in early 2009, global equity and credit markets staged furious rallies, posting some of the strongest gains in decades, and volatility in those markets declined from all-time highs. Consumer confidence increased, and housing prices and job losses may be stabilizing. The balance sheets of financial firms seem more solid, retail sales have increased, and manufacturing is growing again, as are the economies of many countries around the world. And the dollar has been declining, making U.S. goods and services more attractive to foreign buyers and foreign investment returns more attractive to U.S. investors.

The Economy. Does all this mean that the hard times are over and the investment outlook for 2010 is positive? Despite some good news, the economic recovery is fragile, and some large clouds cover the horizon, making it difficult to see the way ahead. For example, commercial real estate continues to suffer from its worst downturn since the early 1990s, with declining rents, investment write-offs, and reduced borrowing. Consumption spending, which makes up over 65% of the U.S. economy, will have a hard time achieving recovery-like growth. Unemployment will be stubbornly persistent and individual incomes for the vast majority of Americans will continue to decline as they have since the beginning of the decade.



Government stimulus, in the form of increased spending, low interest rates and purchases of fixed-income securities, provided a basis for improved conditions in the latter half of 2009 and will continue to do so into 2010, but support for significant additional fiscal and monetary stimulus is wobbly at best. The prospect for fundamental financial system reform is also unclear at present. Consequently, we expect robust economic growth north of 4.5% on an annualized basis for the fourth quarter of 2009, declining to a little less than 3% for the first quarter of 2010 and about 2.5% for the full year.

The Markets. What should investors look for in 2010? Based on the economic outlook and public policy uncertainty, we believe short-term interest rates will begin rising later in the year, as the yield curve flattens, and that the conditions for rising stock prices will peak in the beginning of the year. One of the forces lifting stock prices has been the fact that corporate earnings growth has been relatively good, driven by reduced capital and compensation costs as well as favorable comparisons with 2009 earnings figures.

The U.S. dollar will likely decline further and inflation will remain benign. Many foreign economies are recovering more quickly than the United States, all of which bodes well for business and investment conditions. However, positive elements in the outlook depend largely on actions by government and business that may not be repeated. Last year, corporate earnings growth was aided by the ability of many businesses to cut costs faster than their sales declined. Now businesses hope that sales increases will lead to further earnings growth. If not, they may not be able to sustain earnings growth commensurate with recent stock price increases. Without additional federal spending and monetary stimulus, local governments and consumers may not be able to support demand until unemployment abates and incomes increase. Among other things, this could put pressure on stock and bond prices.

Asset Bubbles. Perhaps most important, even in the aftermath of the housing and stock market meltdowns, the era of extreme asset bubbles may not be over. A large pool of global capital available for investments, uncertainty among investors about relative future returns for various asset classes and an uncertain regulatory landscape, all create conditions where bubbles could occur — but not necessarily will. Certain asset markets and sectors, such as emerging market stocks and bonds, high-yield

bonds, inflation-linked bonds and financial services, have experienced outsized gains over the past year. Growing valuations in these and other areas could signal the need for caution in selected asset classes. Among other things, investors should consider strategic asset allocation, which includes adopting a diversified portfolio appropriate to their needs, regularly reviewing asset allocations, and beginning to correct any apparent emerging distortions through rebalancing.

INVESTMENT MARKETS GYRATE

Equities. The performance of financial markets in 2009 was, to say the least, remarkable. After hitting bottom on March 9, 2009, (after a peak-to-trough decline of over 55%, since October 2007), including a drop of about 25% in the first two months of 2009), broad U.S. equity indexes experienced their best three-quarter performance since the Great Depression, with the S&P 500 and the Russell 3000 up over 26% for the year and 16% in the third quarter alone. The big story in equities was overseas, as a declining dollar and, in some countries, rapid economic growth were reflected in climbing dollar-denominated foreign stock prices. Led by an early recovery from the global recession in China and, to a somewhat lesser extent, in India, Asian (except Japan) and other emerging market stock indexes rose between 70% and 80% in 2009. Developed country equity markets around the world, led by Europe, outpaced U.S. equities by returning over 30%, in dollar terms. Small-cap international stocks were especially robust, rising over 45% for the year. The exception to these upward moves was in Japan, which continued two decades of stagnant economic and investment market performance.

In the United States, in keeping with the nature of early-cycle stock rallies, midcap and growth indexes led the way in 2009, returning between 30% and 40% for the year. Investors rediscovered value stocks briefly during the third quarter of the year, when they outperformed growth stocks, but in the fourth quarter investors returned to growth stocks, leaving them significantly ahead of value indexes for the year.

Fixed Income. Fixed income markets also showed 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 about

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6% for the year. Of that, corporate bonds, particularly high-yield bonds, were the big performers. The broad U.S. credit index of non-government bonds, after falling about 3% in 2008, rose almost 16% in 2009. The narrower high-yield bond index returned over 50% in 2009, after dropping about 26% in 2008. In contrast, after returning over 12% in 2008, the U.S. government bond index fell over 2% as investors lost their enthusiasm for U.S. Treasuries.

These results show a sharp reversal from 2008, when investors shunned the credit markets generally in favor of government securities. This year, recognizing that prices had dropped as yield spreads skyrocketed, investors returned enthusiastically to credit securities. One exception was U.S. inflation-linked bonds, or TIPS (Treasury Inflation Protected Securities), which had posted 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, and TIPS outpaced other government bonds, returning nearly 11.5%. Similarly, municipal (state and local) government bonds underperformed their historical averages in 2008, but they provided nearly 10% returns in 2009 as investor fears about state government finances abated somewhat. In addition, the emerging market bond index, which posted a loss of over 16% in 2008, bounced back with a gain of about 36% in 2009 on the strength of positive economic news from a number of developing countries.

Real Estate and Alternatives. Amid all the positive investment news, special mention should be made of commercial real estate. REITS, which are stocks of companies that invest in commercial real estate, rose over 30% during the third quarter and nearly 28% for the full year in 2009. In contrast, REITS had fallen nearly 40% in 2008 as investors recognized the extent of the residential and commercial real estate downturn.

Direct real estate investment – the 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, and returns fell over 20% during 2009. On the other hand, rental incomes for occupied properties are still relatively stable, and building values may now be in the process of bottoming out. Some lenders are facing further write-offs, and many borrowers will continue to have trouble refinancing.

Investments in other areas are showing some signs of life. Many investments in assets that are not traded on public exchanges, such as private equity, natural resources and distressed debt, were especially illiquid during parts of 2008 and 2009 as the gap between what sellers were willing to take and buyers were willing to offer increased significantly. By some measures, sellers have made certain assets in these categories more available for purchase as the new year begins.

U.S. EQUITY MARKET TOTAL RETURNS

	MTD AS OF 12/31/09	QTD AS OF 12/31/09	1 YEAR AS OF 12/31/09
Russell 3000® Index	2.85%	5.90%	28.34%
Russell 3000® Growth Index	3.48%	7.65%	37.01%
Russell 3000® Value Index	2.21%	4.17%	19.76%
Russell 1000® Index	2.43%	6.07%	28.43%
Russell Midcap® Index	5.70%	5.92%	40.48%
Russell 2000® Index	8.05%	3.87%	27.17%

OTHER DOMESTIC EQUITY MARKET INDEXES

S&P 500	1.93%	6.04%	26.46%
Dow Jones Industrial Average	0.95%	8.10%	22.68%
Nasdaq Composite	5.87%	7.17%	45.32%
FTSE NAREIT Equity REITs	7.15%	9.39%	27.99%

GLOBAL EQUITY MARKET TOTAL RETURNS MSCI INDEXES*

USA	2.01%	5.87%	26.25%
Europe	1.51%	3.24%	35.83%
Pacific ex Japan	2.22%	5.16%	72.81%
EAFE Small	0.75%	-1.03%	46.78%
EAFE	1.44%	2.18%	31.78%
Japan	0.77%	-2.76%	6.25%
Emerging Markets	3.95%	8.55%	78.51%

*Returns are in U.S. dollar terms.

FIXED INCOME MARKET TOTAL RETURNS BARCLAYS CAPITAL INDEXES

U.S. Aggregate	-1.56%	0.20%	5.93%
U.S. Government	-2.27%	-1.00%	-2.20%
U.S. Credit	-1.00%	1.03%	16.04%
U.S. Corporate High Yield	3.28%	6.19%	58.21%
Municipal Bond 10-Year	-0.32%	-1.27%	9.85%
U.S. TIPS	-2.19%	1.76%	11.41%
Global Emerging Markets	-0.46%	2.23%	35.61%

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THE ECONOMY

Asset prices 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 stock market gains that have already occurred. Many companies have cut capital expenditures and payroll and benefit costs severely so that any current and future sales increases are likely to affect corporate earnings positively and immediately. Good sales and macroeconomic news during the beginning of 2010 could provide a favorable tailwind for further equity and corporate bond returns. In contrast, poor sales and unfavorable corporate earnings news could quickly turn into a headwind for markets. On the inflation front, a significant uptick in consumer prices would justify the strong TIPS returns seen recently and hurt other bond returns.

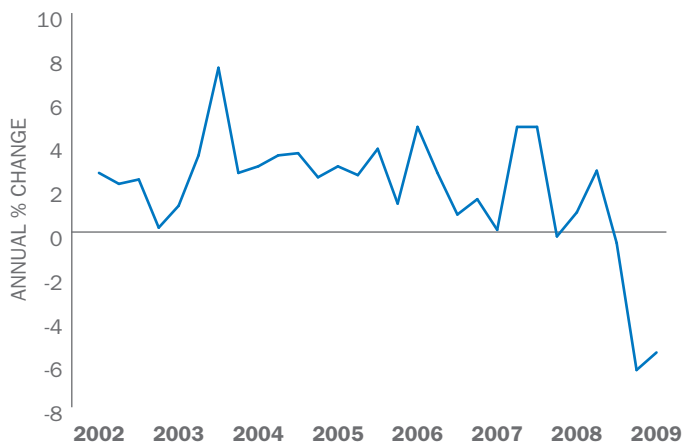
After the Fall. The Great Recession of 2007-2009, which had its origins in the meltdown of the housing finance bubble, will show an overall downturn in the U.S. economy greater than 4%. In the first and second quarters of 2009, U.S. GDP declined about 6% and 0.7%, respectively, on an annual basis, following a 6% drop in the fourth quarter of 2008.

Although the recession was the sharpest and longest since the Great Depression, the U.S. economy at the end of

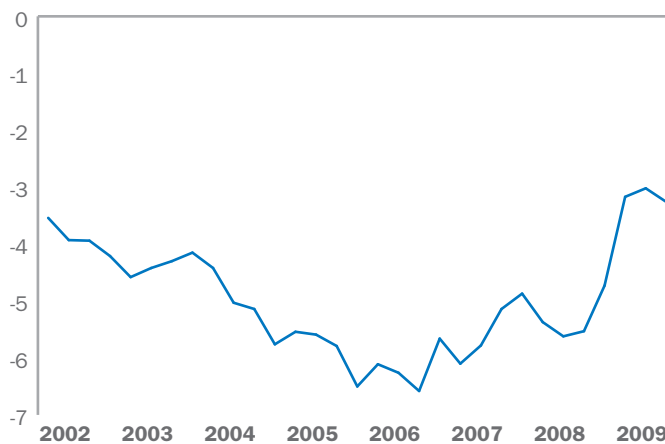
2009 was more positive than when the year began. In the third quarter of 2009, the U.S. economy rose about 2.2% on an annual basis, largely due to the effects of federal spending stimulus, a rise in exports relative to imports, and modest increases in business inventories and personal consumption. We expect positive economic growth in the fourth quarter of about 3% due to the continuation of these same forces. When the figures are announced, second half U.S. economic growth could turn out to be modestly positive – about 2.5% on an annual basis.

Federal Stimulus and Foreign Economies. Among the positive signs, federal stimulus spending had a significant effect on national consumption in the latter half of 2009, a trend that should continue in the first half of 2010. In addition, housing starts and sales have improved, credit markets continue to thaw, the trade and current account balances have improved, deflation has abated, and manufacturing and retail sales have turned up. Anticipating future economic growth, long-term interest rates have risen so that the U.S. Treasury yield curve is as steep as it has been in decades. 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, Europe's largest, to decline about 5% this year, somewhat less than previously forecast.

GROSS DOMESTIC PRODUCT (GDP)



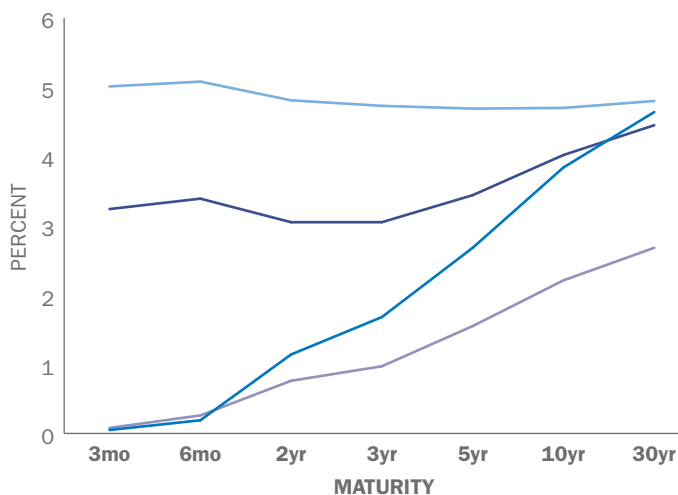
CURRENT ACCOUNT CHART



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Limitations. Among less positive signs, any U.S. recovery will be “jobless” for some time to come, similar to previous but milder recessions over the past two decades and following less-than-robust job creation during the non-recession years of the most recent decade. In addition, news from the housing sector remains mixed at best: construction spending continues to fall; troubled mortgage assistance is far from robust; and regional banks continue to fail. Even the recent rise in manufacturing will prove transitory unless consumers begin buying what is being produced. The recent rise in household savings – from zero to about 5% of income – would be good for long-term economic health because it increases sources of domestic investment. In the short run, however, any savings increase means a drop in consumption, which is the largest component of the economy. And long-term interest rates reflect not only investors’ beliefs about economic growth, but also the reality of funding the large, rapid increase in federal debt now under way.

YEAR-END YIELD CURVES



— 12/31/2009 — 12/31/2008
— 12/31/2007 — 12/31/2006

Note: Interpolated yields displayed

MARKET AND ECONOMIC OUTLOOK: THINGS TO WATCH FOR

After an outright decline in 2009, we expect the U.S. and foreign economies will experience positive growth in 2010 of 2.5% and 4% respectively, well below the long-term growth potential. Consequently, the economic outlook is uncertain, and any number of disappointments could stymie or delay progress. Moreover, economic growth and conditions favorable to rising stock prices will peak in the first half of 2010. Economic growth will likely rise in the first quarter at an annualized rate of about 3%, which is roughly the long-term expected U.S. GDP growth rate, but will taper off as the year progresses. Disappointing corporate profits, low-to-negative job growth, a geo-political shock or a chill in the credit markets could dampen or even quash nascent economic growth. Key factors affecting this cloudy picture include public policy, the value of the dollar, income growth and the propensity for asset bubbles.

Public Policy. In the near future, economic growth will continue to 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 has now kicked in and will continue for another year or so. 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. In the new year, look for a contentious national debate on the need for additional government stimulus.

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The Dollar. The U.S. dollar will continue to be volatile, but a long-term downward trend in its value should continue. After peaking in 2002, the dollar's value, which rose temporarily during the recession as investors sought the relative safety of U.S. Treasuries and other U.S. investments, has continued to fall in recent months. This trend is based on investors' appetite for foreign assets, the current and projected U.S. federal budget deficits and relative economic growth rates around the world. The likely resumption of China's policy of gradual currency appreciation is another factor. 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. This includes not only foreign stocks and bonds, but also the foreign operations of U.S.-based companies.¹

VALUE OF THE DOLLAR



Individual Incomes. A third major factor that will determine the recovery's trajectory is individual income growth. Inflation-adjusted household income fell during the last decade for most Americans, with the exception of the 2% of the workforce with professional degrees (business, law, and medicine). While income declines during recessions are common, they are not common during economic

expansions. Rising incomes could fuel consumption and investment, which could, in turn, benefit corporate profits and economic growth. More likely, a continuing decline in incomes will, instead, act as a drag on consumption, profits and investment returns.

GROUP	EMPLOYMENT SHARE ²	EARNINGS GROWTH ³
Not High School Graduate	9.1%	-0.1%
High School Graduate	28.8%	-3.9%
Some College	27.9%	-7.8%
College Graduate	21.8%	-5.6%
Master's	8.9%	-7.0%
Ph.D.	1.6%	-2.2%
MBA, JD, MD	2.0%	5.6%

Inflation. In contrast to the problematic factors we've considered, conditions are such that inflation will remain benign, with the effects of new federal debt issuance and rising short-term interest rates offset by limited wage pressure due to 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 relatively low economic growth for the next several years. Consequently, long-term interest rates will probably end the year near their current levels.

Asset Bubbles. Instead of general, across-the-board consumer price increases, investment markets will continue to be vulnerable to asset bubbles. The large pool of global savings available for investment, today's 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 dot-com or growth stocks, housing and financial stocks. Mitigating factors include possible significant financial system reforms, which are now being considered by Congress, and potential future agreements among leading nations, such as those discussed by the G-20 nations at their recent

¹ The basic dynamic set up by a declining dollar is that foreign currencies required to buy foreign assets are purchased with relatively more expensive dollars and then, later, when the foreign assets are sold, the resulting foreign currencies are used to purchase relatively cheaper dollars.

² Share of employed workers in the labor force

³ Change in mean real total money earnings by educational cohorts of workers of all races and sexes aged 25 and older, 2000 through 2007

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conference in Pittsburgh. Watch especially for the debate in Congress over financial system reform to see what new responsibilities may or may not be assumed by the federal government to prevent future asset bubbles or mitigate their effects. Fed Chairman Bernanke's comments about the role of regulatory failure in the financial crisis suggest that the Fed will attempt to tighten up its own supervisory activities even without help from Congress.

Peaking Performance. Given this uncertain outlook, without additional government stimulus, current conditions and trends will constrain recently high-performing asset classes, beginning in the first half of 2010. If U.S. TIPS, corporate bond and growth stock returns continue to rise, valuations will become stretched, and these assets will become relatively less attractive. Within equities, these same forces will bring about a shift away from highly cyclical sectors toward those with more stable revenues; specifically this could mean rotating out of financials, technology, and discretionary sectors and into the consumer staples and healthcare arenas.

What might cause this picture to turn out differently? Unfortunately, the fragility of the economic and market recoveries is real. Poor economic news, stagnant company sales figures, a meltdown in Asia, and inappropriate economic policy actions could all challenge the recovery,

and unexpected events, such as a war or an energy interruption, could drive U.S. and foreign economies back into recession. The possibility of asset bubbles and increased economic and market uncertainty underscores the general wisdom of strategic diversification and asset allocation, but it also suggests that investors should increase their vigilance. Strong market movements – up or down - should be seen as occasions for rebalancing back toward a desired portfolio. Otherwise, what was thought to be a balanced portfolio will lose that balance and run the risk of reinforcing market swings rather than trying to mitigate their effects. Rather than chasing the current hot asset class, investors may do well by looking to diversify, even within broad asset classes. Equity investments, for example, should be scrutinized to see whether they have a sensible balance of small and medium capitalization stocks, as well as foreign stocks, to go along with large-cap U.S. stocks. Fixed income investments should be examined to see whether they are unintentionally overweighted to U.S. Treasuries or high-yield bonds. In all of these cases, investors should call upon a trusted advisor for a portfolio checkup and help with any actions that might be warranted in light of that checkup.

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