

OCTOBER INVESTMENT INSIGHTS PODCAST

WITH BRETT HAMMOND

October 2011

Senior Economist Brett Hammond shares his perspective on the third quarter and what to expect for the remainder of 2011.

Welcome to another edition of TIAA-CREF Investment Insights. Today is October 5th. I'm Pete Moore. Joining me is our Senior Economist Brett Hammond. Brett, we just closed the books on one of the most volatile quarters we've seen in some time.

No question about that, Pete. It was rough going for the economy and the financial markets, especially stocks.

Let's start with the U.S. economy. About midway through the third quarter, we saw some pretty substantial downward revisions to GDP growth rates—not just for the first and second quarters of this year, but going back to the Great Recession.

That's right. As part of the government's annual revision of GDP data, we learned that the Great Recession of 2007-2009 was even worse than originally thought, in terms of how much the economy contracted, while the recovery since then has been even less robust.

Obviously a disappointment considering that the economy seemed to be picking up steam around this same time last year, and hardly anyone was talking about the possibility of a double-dip recession.

We're still not forecasting a double-dip recession, but the risk has increased. The economy continues to grow, slowly and painfully. We expect GDP growth will come in at about 2% for the third quarter just ended, a little over 2% for the fourth quarter, and a little under 2% for the year as a whole.

At the end of the second quarter, you described the economy as being “stuck in the mud”—and that was even before the downward revisions to GDP were announced.

Now I'd say it's like we're crawling along the bottom, and every once in a while we come up for air. That's the image that keeps coming to mind. Plus there's still a danger of falling into a deeper trench.

When you say that on occasion we “come up for air,” you're referring to—

— well, pockets of improvement in the economy that are certainly welcome, but don't last long and haven't sparked growth that's strong enough to eat away at stubborn 9% unemployment, one of the really troubling legacies of the financial crisis and Great Recession.

So a fleeting bright spot might be weekly jobless claims that come in lower than expected, or a monthly payroll report that surprises on the upside ...



Or even something like a positive trend in housing prices, which actually rose for the fourth consecutive month in July, after a long string of declines. But the overall housing market remains stuck in the doldrums.

Now Brett, the kind of short-term blips you're talking about have not been lost on the financial markets.

Not at all. Another legacy of the financial crisis and Great Recession has been an increase in volatility in the stock market on a day-to-day basis, and even on an intra-day basis, as investors react to these blips in a way that seems disproportionate to their significance. And by the way, the volatility goes in both directions. In the third quarter we saw that even modestly good news could fuel a massive rally, while the next day a mild disappointment could send stocks tumbling just as far or more on the downside.

Brett, hasn't short-term sensitivity always been a fact of life on Wall Street? There's an old joke about the stockbroker who complained that "Earnings beat expectations, but not by as much as expected."

That's an oldie but a goodie—and of course, exaggerated market responses are not a new phenomenon. What has been changing recently is the scope of volatility—the size of daily market moves not just in terms of the number of points up or down, but as a percentage of the total index level.

You recently looked at some data for the Dow Jones Industrial Average that bears this out. What did you find there?

We tracked the one-day moves of the Dow for the months of August and September. If you remember all those triple-digit closes in August, for example ... there were times when the index was down hundreds of points one day, up a similar amount the next, down again the next, and so forth and so on. In percentage terms the daily swings averaged about 2% in August and over 1½% in September. Results were similar for the S&P 500 Index, which is a broader measure of the U.S. stock market than the Dow.

So daily moves averaging 2% up or down...

... well, that's much more volatile than the 30-year average of about three-quarters of a percent per day.

Bad news for market timers, to be sure.

Absolutely. Which is precisely why, as always, we urge investors to take a long-term view and not try to time the market. Extreme short-term volatility makes it even less likely that you'd be able to pick just the right "down" day to buy and just the right "up" day to sell.

Not to mention that in the third quarter, the down days prevailed.

Without a doubt. U.S. stocks lost about 15% in the quarter and were down almost 10% year-to-date. International stocks declined even more, about 19% in developed markets and 23% in emerging markets.

Brett, why do you think the markets seemed so much more fixated on daily or even hourly headlines in the third quarter? What about company fundamentals?

Good question. Over the long term, company fundamentals, and in particular, corporate earnings growth, are still a key driver of stock prices, but we're in a period where markets are especially vulnerable to being roiled by other factors. It was easier for the market to shrug off bad news when corporate profits were growing at a 35% clip or even higher in 2010. But now they're growing at a substantially slower rate, less than 10%. Investors sense there's less of a cushion to absorb any external shocks to the system.

One of the things that the markets have been reacting to—and this is more than a blip, of course—is the European sovereign debt crisis. Maybe even more than the fear of a double-dip recession in the U.S., anxiety over Greece and some of the other fiscally weak nations in the eurozone has really driven global equity markets.

That's right, Pete. While some incremental progress has been made, Greece has announced that it won't hit its fiscal targets this year. And there's clearly no consensus yet on how to structure a credible long-term solution—one that enables Greece to avoid defaulting on its sovereign debt obligations and that satisfies both the European Central Bank and the interests of stronger individual EU member nations, where there's some serious internal political disagreement over the issue.

Sounds like policy gridlock, something we've become all too familiar with here at home.

Definitely. The role of public policy has become more critical than ever to economic and market prospects in the U.S. Unfortunately, the debate has often been less than constructive, as we saw with the protracted stalemate over raising the U.S. debt ceiling this summer.

That debate did little to inspire confidence, but it did inspire Standard & Poor's to lower the United States' "AAA" credit rating.

And the day after that was announced, the stock market tumbled 5½%, as investors were unconvinced about the federal government's commitment to solving our immediate economic problems.

That time it was really the bond market that shrugged off the bad news, wasn't it? Our national credit rating went down, yet demand for U.S. Treasuries went up. It seemed almost counter-intuitive.

Well, Treasuries are still seen as the safest, highest-quality sovereign debt around, despite the lowered credit rating. From an investor's perspective, which asset would you rather own: a bond backed by the U.S. or a bond backed by, say, Greece—or even France?

Point taken. And since we're on the subject of bonds, what do you think is in store for fixed income and other asset classes for the remainder of 2011?

Many fixed-income sectors have already done quite well in 2011, on top of strong performances in 2009 and 2010. U.S. Treasuries in particular have benefited from a sustained flight to quality. And don't forget about Operation Twist, which is the Federal Reserve's latest effort to provide monetary stimulus to the weak markets and to encourage lending. The idea there is for the Fed to sell short-term securities and buy longer-dated bonds to lower long-term interest rates. This should be good for bond prices, too.

In contrast, the equity markets seem to have their work cut out for them.

In general, I think equity investors will be better served by looking beyond the broadly bearish market sentiment and focusing on individual names, particularly within the large-cap category—where you're more likely to find companies that derive a significant portion of their revenues from overseas operations or from exports.

Commercial real estate, unlike residential real estate, has been generating positive returns this year. Any thoughts on the prospects for this asset class?

Well, we can't predict the future returns, of course, but commercial real estate certainly outperformed equities in the third quarter and year-to-date. Real estate has low correlations to other asset classes and a performance cycle that generally lags developments in the macro economy and capital markets. That's why real estate historically has been an effective way to diversify a portfolio of stocks and bonds. And fundamentals for this asset class continue to improve.

So commercial real estate is up ... but commodities are down.

Commodities, which investors sometimes turn to as an alternative asset class or a hedge against inflation, were quite volatile in the third quarter. Prices for metals, oil, and agricultural products moderated, and in some cases, plunged from their recent highs.

So Brett, would that be on fears that a global slowdown would dampen demand for raw materials?

In part, but I also think a sharp downturn in commodities prices was inevitable given how fast and far they had risen.

So another bubble?

Essentially, yes. Now, one way to get exposure to commodities with less market volatility is through investment in the underlying natural resources.

For example, instead of investing in corn or soybean futures ... maybe an investment in farmland?

Over time, farmland has proven to be a more stable investment than the crops that grow on it.

We should mention that some of the alternative assets we've been discussing today aren't necessarily appropriate for all investors, or readily available to them.

One that is readily available, Pete, and can be a suitable part of a diversified, long-term retirement portfolio, is the guaranteed asset class.

An example being a fixed annuity ...

Yes, it not only guarantees the safety of your money and offers attractive diversification benefits while you're saving, but it also provides guaranteed lifetime income options when you retire.

Subject, of course, to the claims-paying ability of the issuing insurance company.

That's right. And as always, we encourage investors to work with a trusted advisor who can help them create or modify a diversified portfolio that's aligned with their needs, goals, and ability to tolerate risk. It's an approach designed to work not just in volatile times, but all the time.

And Brett, that is all the time we have today. Thanks as always for sharing your perspective on what's been driving the economy and the markets, and what we might expect to see in the final quarter of the year.

Delighted to do it.

This has been the October edition of TIAA-CREF Investment Insights. Be sure to visit our website, tiaa-cref.org, for more perspectives on the economy, saving for retirement, and how to weather market volatility. I'm Pete Moore. Thanks for listening.

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