

# INVESTMENT INSIGHTS: MAY PODCAST

## WITH BRETT HAMMOND

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### Chief Investment Strategist Brett Hammond talks about the European economy and its impact on the United States

Welcome to TIAA-CREF Investment Insights. Our monthly discussion of market and economic events. Today is May 25. I'm John Wilkens and we're joined as usual by Brett Hammond, TIAA-CREF's Chief Investment Strategist.

Brett, we've got a lot to talk about today – Greece of course, the I guess, bifurcation between last week's more rosier growth and employment outlook from the Fed, a sizable increase in consumer confidence and the decidedly less rosy direction the markets have been going in lately. And we'll get to that in a minute. But there's one issue I've been dying to ask you about since it happened. The 900+ pound gorilla in the room - how on earth did the stock market drop nearly 1000 points for what seems like no good reason?

**Oh that was on May 6th. Like everyone else, it took me back a little.**

It was one of those times where we remember where we were when it happened.

**Yeah, I was actually at Wellesley College that day – talking to participants about the importance of taking a long-term approach to investing.**

Well I guess they left the presentation and got a rather unpleasant real world example of what you're always telling us – market timing is a dicey proposition.

**Focus on the long term. It's sometime's hard to do when we get sensational financial news every second of every day, but that's the key.**

Speaking of short term, my favorite headline from that day. "The Great Crash of 2:45 p.m."

**Or "The Flash Crash." Around noon I checked the markets, which were down, but within the bounds of normal incremental trading. Later, I went to the airport for my return flight to New York, and the TV showed the Dow down 938 points! Quite a surprise, but by the time I got my boarding pass the market had already started its rebound. I boarded my plane a little while later and by then the market was down only 400 points or so.**

I think it closed down a little more than 300 points for the day. Comparatively not so bad I guess. But what do you think happened? I mean, did one trader with, what was the phrase that was in the news, fat fingers, actually send the entire stock market into complete turmoil?



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**Well one of the earliest stories was that a single trader pushed the wrong button on his keyboard when he wanted to sell a position in Proctor & Gamble – the “b” for billions of shares instead of the “m” for millions of shares.**

But other theories have emerged?

**Yes. Last week regulators were taking a look at trading in specific S&P Futures contracts – derivatives that get their value from changes in the underlying S&P index. A trading algorithm that was supposed to limit trading volume may not have worked as planned.**

There're supposed to be brakes applied when something like this happens. Were they not applied?

**There are brakes and they were actually applied. Trading in some securities and certain derivatives was stopped. In addition erroneous trades were later reversed. After extreme market downturns in '87, '98 and 2001, the New York Stock Exchange, the NASDAQ, and other well-known exchanges developed what they call circuit breakers to stop trading when a stock or an entire market falls outside of a preset range. But these safety devices were designed for when most trading was done on the major exchanges.**

**Today, not only are more and more trades done through automated computer-driven methods, they are occurring more frequently in smaller, off-exchange markets. Alternate Trading Systems as they're sometimes known. Perfectly legal of course, and generally they're beneficial because they reduce costs and enable higher volume, around-the-clock trading.**

But isn't the issue here that the regulatory brakes that exist in the major markets such as the NYSE aren't uniform across these other locations?

**And trades that aren't executed fully in one area can bounce to other trading arenas for execution, which is what happened a couple of weeks ago. As trading began to shut down in some areas, more and more sell orders bounced to the off-exchange markets and in several cases overwhelmed them. That's why you saw Sam Adams beer trading for \$1, a transaction that was annulled the next day when they began to sort out what happened.**

Now that we've seen firsthand the effects of the lack of integration, do you expect changes?

**I do. The SEC is already looking at the issue. And I think we'll see movement towards a more comprehensive synchronization of rules in the near future.**

Let's get back to the markets Brett. In the past few weeks we've seen stock markets around the world fall as investors seem to be getting cold feet. Some short-term investors are even putting money back into U.S. Treasuries, driving down yields of longer term bonds. And yet, last week the Fed announced somewhat more optimistic numbers for U.S. growth and unemployment in 2010. Does that assuage any of your earlier concerns?

**Well the Fed Open Market Committee – or FOMC recently increased its estimate for 2010 GDP growth to about 3.5%. That’s an increase of about half a percent. And it reduced its year-end unemployment estimate to a number closer to 9% than the nearly 10% it is now.**

**In addition, we’ve had modestly good real estate news, where housing starts were up about 5% in March, largely, I think, due to the stimulus generated by the now expired Home Buyer Tax Credits program. It remains to be seen how much of this momentum carries forward. Keep in mind that the Fed is emphasizing a higher than usual amount of uncertainty about the economy. I share that view and would point particularly at the consumer.**

And speaking of a higher than usual amount of uncertainty Brett, let’s move on to Europe. The Greece problem is still there. Today in fact – May 25th to be precise - European markets are down about 3% as we’re talking. Do you think we’ve done a better job of dealing with these kinds of things than the Europeans? California had what seemed like similar problems.

**That’s part of it. But it’s also important to remember the situation is very different. The creation of a common currency– the Euro -- facilitated trade and increased growth. But the Greek crisis starkly illustrates some of the downside when 22 European countries use a common currency as opposed to 50 U.S. states.**

**For one thing, Portugal, Italy, Ireland, Greece and Spain, known as the PIIGS or P.I.I.G.S., can’t use one of the traditional devices to adjust to difficult times by devaluing their own currency – that would make exports cheaper for example – and that’s because they don’t their own currency. The alternative is to reduce prices and wages and government spending, things that are extremely hard to do both economically and politically.**

**Also, they can’t set their own short-term interest rates and they can’t print more money to buy up their distressed securities and increase aid to local governments as the U.S. did over the last couple of years.**

But there was a European bailout package announced though. A nice round number.

**After a lot of hemming and hawing. Nearly a Trillion dollars in loan guarantees from other European nations and the IMF. But there are two difficulties. First, loan guarantees are just that. They aren’t direct aid and they don’t remove the need for Greece to take unpleasant austerity measures.**

**And second, it only highlights the irony where countries such as Germany who have done a good job of keeping their economic house in order are now underwriting Greece, which hasn’t.**

I guess necessarily. But it has to be a pretty unpopular step if you’re a German politician, or German taxpayer for that matter.

**Hence the reticence. And the effects are being felt, not just in Germany and Greece, but all over the world as the value of the Euro drops and stock markets fall. Even in China, where exporters will have more difficulty selling goods and services to Europe, therefore, investors are worried about economic and stock market growth. But I think the drop in the Euro will improve the valuations of European stocks. And while China's growth rate may abate somewhat, it will remain robust.**

I think I'm fair in saying Brett that your prognosis for our recovery has grown slowly more optimistic of late. But do you think all of this is a game changer?

**Now I think markets are looking for fundamental factors that can continue to underpin future growth. The federal government's fiscal stimulus spending, though not much in the news lately is pretty much at its peak right now. As federal spending falls over the next year or two, we'd like to see consumer spending pick up even more than it has and continued increases in corporate earnings. These things would underpin economic growth and make it easier for investors to continue to push up the stock market.**

**But a game changer? I don't think so. In the short term, markets go up, markets go down. On May 6th we saw an all too clear example that they can do so incredibly quickly. That's precisely why a taking a long term outlook to investing is still the right approach. Focus on the long term. Be appropriately diversified across asset classes, and think carefully about the role guaranteed income can play to replace income in retirement, and protect against declines.**

Brett, thanks for joining us. This has been Investment Insights from TIAA-CREF. Thank you for listening.

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