

INVESTMENT INSIGHTS: FIVE QUESTIONS WITH MARTHA PEYTON

Head of Global Real Estate Strategy and Research

June 9, 2010

Head of Research and Strategy for TIAA-CREF Global Real Estate discusses economic recovery, recent volatility and what investors can expect going forward.

Will economic recovery here in the US be derailed by recent market volatility?

I spend a great deal of my time analyzing the US macro economy because it is so important for commercial real estate. If I look at what's happened in the last few months in the Euro zone with regard to debt crisis, Portugal, Greece, Ireland, Italy and Spain, I'm not seeing enough there to derail the recovery that has begun in the US economy.

We are seeing the beginning of growth momentum take hold. We've had three quarters now of GDP growth. We're seeing a lot of indicators that support continuation of that growth through at least the medium term. For instance the consumer sector is certainly healing. Consumer confidence is much better now than when it bottomed out a year ago. Consumer spending was up 3 1/2% in the first quarter GDP report.

The business sector is improving. Corporate profits in the first quarter were up at a 30% rate. Equipment and software investment has been one of the drivers behind economic growth over the last few quarters.

The commercial real estate sector lags the rest of the economy. We are however seeing a beginning of a turnaround in the form of stabilization in occupancy rates in office property, industrial property, retail space and multi-family. We're seeing an uptick in leasing activity and increased willingness among tenants to commit to leases and take advantage of today's lower rents.

Finally I think we've got to point to employment and recognize that there's a very long way to go in regaining the 8 1/2 million jobs that were lost during the recession but since the beginning of 2010 we've added almost a million jobs. Some of them, a good number of them, are temporary jobs related to the 2010 census, but they are jobs and they do provide income nonetheless, and will contribute to the growth momentum that I think we're depending on.

How critical to global recovery are recent events in Europe?

The recent events in Europe with regard to the debt crises affecting Portugal, Ireland, Italy Greece and Spain has been helped enormously by the trillion dollar guarantee or bailout package that has been negotiated over the last couple of weeks. That package has helped to restore liquidity to Euro zone financial markets.

Now the challenge ahead is that the over-indebted Euro zone countries will need to raise taxes, cut government spending, impose austerity measures in order to restore confidence among their creditors. Now that will have an effect on the economies of those countries. It will limit growth.

But they are among the smaller countries in the Euro zone and the larger countries, in particularly Germany, are in very solid shape. The prospect of weaker economic growth in the Euro zone leaves global growth reliant on the US and the BRIC countries. That's Brazil Russia India and China. US growth is expected to be modest, while growth in the BRIC countries has been and is expected to continue to be much stronger.

Is market volatility here to stay?

After the depth of the recession over the last two years, it really isn't reasonable to expect that the markets are going to recover without interruption. Now we do expect that over the next few months that volatility will ease up a little bit because the PIIGS crisis – the debt crisis in Portugal Italy Ireland Greece and Spain, has now been well priced into the market and is no longer a surprise.

The US economy after three quarters of positive GDP growth is much better positioned to deal with market volatility than we were during the recession. Over the past two years an enormous amount of leverage or debt has been wrung out of the system and that leaves us less vulnerable to the negative impact of volatility.

In addition, asset prices are much more reasonable now than they were at their peaks. For instance, the stock market – the Standard and Poor's Index is now at a PE of 13. And that's below its long term average of 15. Residential real estate is now priced 30% less than its peak. Homes are more reasonably priced. Commercial real estate prices are down anywhere between 30 and 40% so commercial real estate is more reasonably priced. All of these factors make us much less vulnerable to the negative impact of continuing volatility.

When will interest rates start rising?

The Federal Reserve controls short term interest rates and as you know the Fed Funds Rate has been held at zero to .25 for quite a long time now. The Fed does not believe that changes in interest rates, monetary policy should come as a surprise to financial markets. But rather that they should give the markets ample warning when a change in rates is likely to happen.

We have not gotten any signals from the fed that a change in short term interest rates is likely to happen in the near term. But rather they will wait until recovery is very solidly in place and until the risk of inflation begins to appear. The risk of inflation now is extremely low because the economy has enormous excess labor and excess productive capacity. The unemployment rate is close to 10% and is unlikely to come down very quickly.

So the Fed should be on hold through the near term and economists are predicting that we won't see an interest rate increase until the end of this year, the beginning of next year at the earliest. We agree with that.

What should individual investors do in times like this?

There's been a lot of attention recently in the media about whether investors should hold more cash in times like these or shift their asset allocation to contain more cash. Those kinds of decisions are very reactive. Very much based on the spike in volatility that we saw in May. Based on worry about the Euro zone debt crisis. Based on concern about the prospects for the US economy.

Basing asset allocation on those short term decisions in my judgment really doesn't benefit investors in the longer run. Asset allocation is a long term decision and should be based on the investor's consideration of the long term, though with awareness that there are short term issues. That there is short term instability and volatility. In a longer term asset allocation view, an investor needs to consider their own particular needs. Their own investment time horizon. Their tolerance for risk. Their need for income replacement

Long term asset allocation. Diversified portfolios. These are the things that have stood the test of time and have weathered the short term volatility that is inevitable in the marketplace.

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