

# INVESTMENT INSIGHTS: 2010 MID-YEAR REVIEW AND OUTLOOK

WITH BRETT HAMMOND

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Chief Investment Strategist, Brett Hammond, analyzes the year so far and details the factors that could impact markets and the economy as we head towards 2011.

As we enter the dog days of summer, the economic forecast and market outlook are a simultaneous "good news and bad news" story. The economic recovery that began in the latter half of 2009 remains positive, but has tapered off. For the second quarter, we estimate GDP rose at an annualized rate of just over 2%, following the fourth quarter of 2009's 5.6% and first quarter of this year's 2.7%.

Unemployment, though, continues to lag, with a record number of people out of work for more than a year. Still, we have seen increased signs of life in industrial production, growing world trade, and increases in new capital spending. All hopefully harbingers of continued improvements.

The news from overseas is also mixed. Europe continues to have debt problems. Portugal's sovereign credit rating was recently downgraded and Greece continues to skirt an actual debt default. On the other hand, Asia, led by China, is growing rapidly.

Investment markets are reflecting all of this economic uncertainty. In the past couple of months, volatility has returned to the equity markets and some investors have returned to the safety of U.S. Treasuries, driving down long-term interest rates. The question is, where do we go from here or, which way is up?

Before we think about where we're going, let's look back at where we were not so long ago. In 2009, economic output, as measured by GDP, fell by 2.4%, following 2008, when output was essentially flat. Unemployment topped 10%.

Underemployment -- which includes people who have given up looking for jobs and those who would like to work more than they are now - climbed to over 18%.

Corporate profits declined by about 12% in 2008 and by another 4% in 2009. And the S&P 500, a broad measure of the U.S. stock market, fell by over 55% between November, 2007 and March of 2009.

Today, the National picture is certainly less bleak than it was. After an increase of 26% in 2009, the S&P is down for the year through July 15, with a 5% increase in the first quarter followed by a decline of about 11% in the second. And corporate profits continue to improve, with indications that overall second quarter earnings reports will be a significant improvement over the first quarter.



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But as with broad market indices, national economic statistics don't always tell the whole story. Employment numbers and other countrywide statistics can smooth over sometimes sizable differences in how individual states or regions fared during the Great Recession and also how well they'll fare post-recession.

Interestingly, the states that fared best during 2008 actually seem to correspond very roughly to those acquired in the Louisiana Purchase and the War of 1812 -- minus Louisiana itself -- Those that fared worst are in the far West, Rust Belt, and the Southeast.

Why these differences? Well they're largely due to the importance of certain industries that are more prominent in some states than in others. These include housing, energy, manufacturing -- particularly autos -- and finance.

Over the last decade the residential housing industry helped to fuel growth in the Southeast, especially Florida and the far Southwest. The principal cause of the national recession -- the credit crunch -- of course fell hardest on areas experiencing the most housing speculation, price increases, and subprime mortgage loans.

On average, Arizona for example suffered from more than a 50% housing price decrease, with Florida, Nevada, and parts of California not far behind. For example, 17% of houses in Nevada are expected to be in foreclosure by the end of this year. In those states, prospects for a rapid recovery in the construction industry are slim and many jobs lost in residential construction and finance may never come back.

On average, energy prices rose over the last several years, peaking in 2008, but they remain today well above the average level over the last 10 years. Energy producing states have benefited from higher energy prices, which stimulate exploration, energy services, and production.

These industries are important to Texas, nearby states, and Wyoming. Ironically, Louisiana would normally be a part of this surge, but the ongoing BP oil spill is more than offsetting the gains from higher energy prices in that state.

Manufacturing is important to many states, but particularly concentrated in the old rust belt states, such as Michigan, Ohio, Illinois, Indiana, and Wisconsin. Layoffs over the last two years hit these states hard and many of the lost jobs will not be refilled. Instead, as the economy improves, employers are looking for higher skilled workers. The principle rust-belt industry, vehicle manufacturing, has been restructuring for decades. It is now changing even more rapidly as GM emerges from bankruptcy and Chrysler was, once again, resold.

The financial meltdown in 2008 affected nearly all 50 states negatively through massive reduction in consumer and business credit and the fallout from the home mortgage crisis. New York especially, but also Massachusetts, Connecticut, New Jersey and California, have become increasingly dependent on the banking and finance industry.

After nearly leading the country into another depression, the financial industry, thanks to federal assistance, rebounded and has contributed positively to these states' economies of late. While some states and industries are doing better than others, the U.S., as a whole is still slowly recovering from the Great Recession but is doing so in fits and starts.

Today, mixed signals still dominate both the financial markets and the economy. But mixed signals are a sizeable improvement from the decidedly one sided signals we were getting not that long ago. Leading economic indicators have peaked -- at least for the time being -- and we're all familiar by now with the market gyrations emanating from news of the European debt problem. Industries that export goods and services overseas may experience positive gains based on economic growth in Asia and Latin America. Commercial real estate markets in big urban centers could begin to see some gains in the year to come.

On the risk side, the low job and wage growth we're experiencing will help drive future labor demand, but at the same time hampers a recovery in consumer spending. We also need banks to increase small-business and consumer lending.

We anticipate growth in the region of 2% on an annualized basis for the remainder of the year, with unemployment beginning to show moderate, but real improvement towards year end. But corporate earnings may not climb as fast in the latter half of the year as they did in the first half.

If we're going to sustain recovery into 2011, and lay the groundwork for future investment market gains, the Federal Government's role is still paramount. Right now, federal stimulus spending is peaking, after ramping up slowly following the February, 2009, congressional stimulus package.

Also, the Fed has affirmed that short-term interest rates will remain near zero, probably into 2011 and it still holds over \$2 trillion in fixed-income securities on its balance sheet. Thanks to these measures, the Great Recession didn't turn into a depression.

But consumers have shown little interest in stepping up their spending enough to replace the federal government's stimulus money and the Fed seems rightly more concerned about deflation and economic slack than about an overheated economy, rising interest rates, and inflation.

In this uncertain time, what can investors expect? The underlying economic and market conditions suggest that equity market volatility will continue to rise and fall for some time and that interest rates will remain relatively low, though perhaps not as low as they are right now. In this light, the right path for an investor depends of course on their risk tolerance and time horizon.

But in general, a prudent asset allocation diversified across major US and overseas asset classes can help you weather the inevitable summer squalls that come our way now that the economic storm has mostly passed.

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