July 2014

TIAA-CREF Asset Management

2014 Mid-Year Economic and Investment Outlook

Executive summary

Timothy Hopper, Ph.D.
Chief Economist

- Global economic growth will continue to improve into the second half of the year, thanks partly to ongoing central bank support.
- Equity markets appear fairly valued in the U.S., with low inflation supporting multiples. High-quality, large-cap companies look best positioned to maintain earnings growth.
- The valuation gap between emerging and developed equity markets should narrow, as emerging market profitability finally begins to recover.
- The temporary factors (weather and unbalanced government debt supply/demand) that have suppressed Treasury yields should fade, so higher yielding parts of the fixed-income universe remain attractive.

Daniel Morris, CFA
Global Investment Strategist

Asset class preferences

Equities ↑	**Fixed Income** ↓
Large Cap ↑	Government Debt ↓
Mid Cap ↓	United States ↓
Small Cap ↓	Eurozone ↑
Growth ↓	Core[2] ↓
Value ↑	Periphery[3] ↑
Developed Markets ↓	Treasury Inflation-Protected Securities (TIPS) ↓
United States ↑	Munis ↑
Europe ↓	Corporate (Investment Grade) ↑
Japan ↑	Residential Mortgage-Backed Securities (RMBS) ↑
Emerging Markets ↑	High Yield ↑
Cyclical Sectors[1] ↑	Emerging Markets ↑

↑ = overweight; ↓ = underweight. [1] Energy, Materials, Industrials, Consumer Discretionary, Financials, Information Technology. [2] Core = Austria, Belgium, Finland, France, Germany, Luxembourg, Netherlands, Slovakia. [3] Periphery = Cyprus, Ireland, Italy, Malta, Slovenia, Spain. Please note the forecasts above concern asset classes only, and do not reflect the experience of any product or service offered by TIAA-CREF. These forecasts are for informational purposes only and should not be considered investment advice or constitute a recommendation to purchase or sell securities. Market forecasts are subject to uncertainty and may change based on varying market conditions, political and economic developments. Past performance is not an indicator of future results.

Financial Services

Global asset returns

	Market Value ($tr)	Relative P/E (%)*	Dividend Yield (%)	Total Return (%) 2Q 2014	Year to Date	Last 12 Months
Equities						
Global (ACWI)	37.7	-5	2.5	4.7	5.7	21.4
Small/Mid Cap	12.7	5	1.9	3.7	6.3	23.4
Growth	18.9	5	1.6	4.6	4.9	21.4
Value	18.8	10	3.3	4.8	6.6	21.4
High Dividend	10.3	3	3.9	5.6	7.7	22.6
Developed Markets	33.6	-2	2.4	4.6	5.8	22.4
United States	18.4	10	1.9	5.2	7.1	25.0
Europe	9.2	7	3.2	3.4	5.4	20.8
Japan*	2.8	-19	1.9	4.9	-2.8	12.3
Asia ex-Japan	1.7	0	3.9	3.0	3.6	16.2
Emerging Markets	4.1	-14	2.6	5.2	4.8	14.1
Asia	2.6	-18	2.3	5.6	5.3	14.7
Latin America	0.8	10	3.3	5.2	3.4	9.7
Europe, Middle East, and Africa	0.8	-5	3.2	4.3	4.7	17.3

	Market Value ($tr)	Duration	Yield (%)	Total Return (%) 2Q 2014	Year to Date	Last 12 Months
Bonds						
Multiverse	48.2	6.3	2.0	2.1	4.2	5.5
Government	24.4	6.9	1.4	1.8	3.8	4.6
United States	6.1	5.2	1.4	1.4	2.7	2.0
Eurozone	7.3	6.7	1.3	3.0	7.0	9.3
Core	4.5	3.8	0.9	2.8	5.7	6.0
Periphery	2.8	4.4	1.9	3.5	9.1	14.9
Japan	6.7	8.3	0.5	0.8	1.6	3.1
Agency	3.2	5.0	1.8	2.0	3.6	4.8
Inflation-Linked	2.3	12.4	0.1	2.9	5.5	4.6
Securitized	6.9	5.7	2.4	2.2	3.9	4.9
Corporate (IG)	7.7	6.1	2.5	2.4	5.1	7.3
Industrial	3.9	6.8	2.7	2.6	5.6	7.3
Financial	3.2	5.0	2.3	2.1	4.2	7.1
High Yield	2.2	3.8	5.0	3.0	6.1	12.5
EM Sovereign (USD)	0.6	6.9	4.7	5.4	9.2	11.9
EM Corporate (USD)	1.3	5.0	4.4	3.9	6.3	9.7
EM Sovereign (local currency)	1.4	5.1	5.8	3.4	4.9	6.2
EM Corporate (local currency)	0.2	4.3	5.0	2.3	3.2	N/A

Data as of 6/30/2014. ACWI = MSCI All Country World Index. IG = Investment grade. EM = Emerging markets. All returns are in local currency unless otherwise indicated. Equity categories are for the respective MSCI index. Bond categories are for the respective Barclays index, except for emerging markets, which are for Bank of America Merrill Lynch indices. * Relative P/E compares current 12-month forward P/E (price/earnings) ratio versus median value since 1987 (except Latin America since 1992, EMEA since 1997, Small/Mid Cap and High Dividend since 1999, and Japan since 2000). **It is not possible to invest in an index. Performance for indices does not reflect investment fees or transactions costs.** Sources: MSCI, Barclays, Bank of America Merrill Lynch and TIAA-CREF Asset Management.

Keep calm and carry on

The global economy finished the second quarter on an upbeat note, driven by stronger results from developed economies and continued easy monetary policy from major central banks. Among the signs of economic strength heading into the third quarter: climbing global purchasing managers indexes (PMIs), rising global trade, and stable or increasing industrial production across most regions *(see Exhibit 1)*. The U.S. economy is the main driver, with an expected second-quarter growth rate of 3.6%. Although still in the shadow of recession, Europe is showing signs of life; its economy should grow by close to 1% in the second quarter. China's growth, though still slowing from last year's nearly 8% rate, looks to stabilize closer to a 7% pace. Japan's economy will shrink in the second quarter due to a sales tax hike, but this should not completely offset its strong first quarter *(see Exhibit 2)*.

Despite fears of an impending market correction, equity markets appear steady. Valuations remain reasonable at just 14.5 times forward earnings estimates for the MSCI ACWI (All Country World Index), compared to a median reading since 1987 of 15.2 times. Earnings growth is solid in key markets (U.S. and Germany, among others), and low inflation supports higher multiples in the U.S. than investors may initially be comfortable with. Interest rates are still well below the levels that real growth and inflation would warrant, thanks to a combination of central bank support and limited supply relative to robust demand. The trend for rising interest rates remains intact, however, requiring riskier portfolios to capture additional yield.

United States

Economy

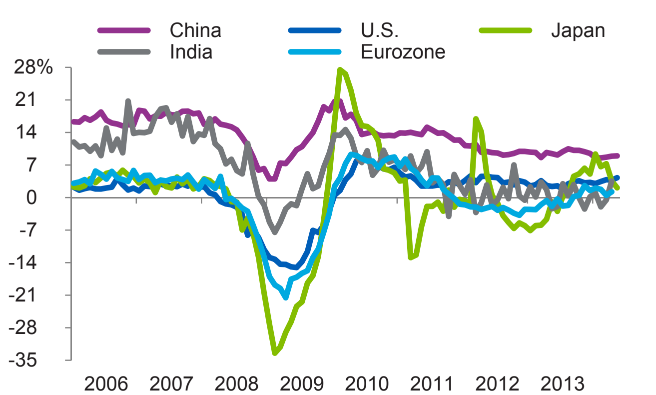
Economic performance during the second quarter in the U.S. is best characterized as a reemergence of the broader-trend growth rate — that is, average growth in the neighborhood of 2.25% — rather than a significant bounce back following the severe winter or an acceleration to a higher level of growth. There is enough evidence to suggest the U.S. economy is picking up steam, but that pickup will continue to be slow and measured.

Several pieces of this puzzle still need to be put in place before economic activity can emerge from its recession dynamics into a more normally behaved expansion cycle. Among these pieces are housing activity, private sector capital investment, improved hiring, wage and income growth, and credit availability. An improvement in housing will take more than just price gains, which we have already seen since 2012. It will also require more home construction and sales, which involves increased mortgage lending and rebuilding the home-construction supply chains that have broken down since the recession. Private sector capital investment, sorely lacking since 2008, needs to improve. Businesses have deemphasized new investment for balance sheet repair and cost-cutting, while individuals have also reduced their aggregate debt burden.

Since the recession, balance sheets have recovered fully, at least in the aggregate. Corporate America is healthy and profitable, and capital costs are near record lows. Individuals

Exhibit 1: Industrial production

Annual growth rate, 2006–present



Sources: Haver Analytics and TIAA-CREF Asset Management. Data as of April 2014 (Eurozone, India) and May 2014 (Japan, U.S., China).

Exhibit 2: Real GDP growth rates

	Real GDP, %		Forecasted Real GDP, %, SAAR*				
	2013	2014	Q1 14	Q2 14	Q3 14	Q4 14	Q1 15
U.S.	1.9	1.7	-2.9	3.6	3.2	3.5	3.2
China	7.7	7.1	5.9	6.8	7.7	7.4	6.1
Eurozone	-0.4	0.9	0.7	1.0	1.2	1.3	1.4
Japan	1.5	1.6	6.7	-5.0	2.4	2.8	2.0
World	2.4	2.6					

* SAAR = seasonally adjusted annual rate. Note: Quarterly estimates for China SAAR do not correspond to officially published YTD figures. Sources: Haver Analytics and TIAA-CREF Asset Management. Data as of 6/30/2014.

have more debt capacity today than at any time during the past two decades, and aggregate debt outstanding has fallen to levels from ten years ago. But income statement repair is not yet complete. Economic turmoil, regulatory uncertainty, and sustained low long-term interest rates have promoted capital preservation over hiring and investment. The good news is that we are beginning to see some improvement in these areas, which suggests the economy is moving toward a more normal cycle.

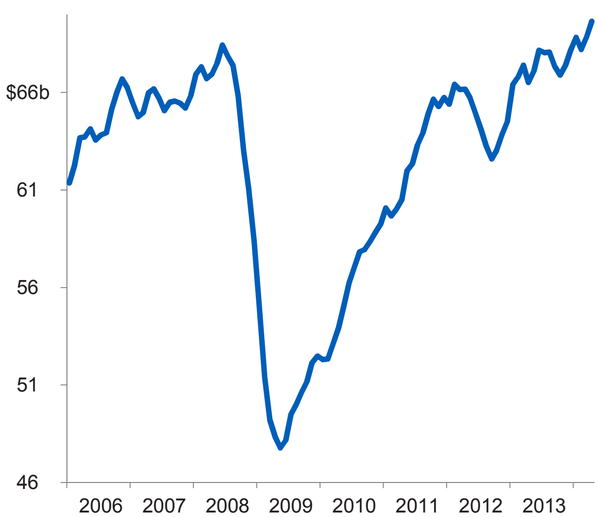
The current economic environment supports stronger growth, which was not true over the past few years. Excess capacity in the economy is shrinking rapidly, while capital stock (equipment and other physical assets) is aging. For corporations, this means that increased investment and hiring are required to increase output, and for individuals this means the old car and the broken refrigerator will get replaced. Capacity utilization in the economy now exceeds 79%, near its long-term average rate. We can also see the recovery in factory order data, which indicates a gradual but steady improvement in capital expenditures, and budding strength in survey data on business activity and sentiment *(see Exhibit 3)*.

The other side of the equation is the wage earner. Without income growth, there will be no serious consumption growth across the economy. This has been one of the primary weak links so far during this recovery. It is also an area where we expect to see some gains during the next few quarters. Wages turned up during the first quarter but have stalled over the past three months. This is especially true for real wages, as nominal wage growth has been outpaced by inflation since March. However, demand for labor services is improving, with an upward trend in hiring that we expect will continue throughout the remainder of this year and indeed improve even more next year. Our forecast calls for average job creation to exceed 250,000 per month by the end of this year and for an unemployment rate of 5.8% *(see Exhibit 4)*.

Despite meager wage growth over the past five years, consumption has held up reasonably well — growing 2.3% on average even amid often volatile economic performance from quarter to quarter. Recently, one source of spending has been non-wage income, i.e., income received from dividends and interest on assets. Consumer debt has also started to rise. These are signals that demand is strengthening on one hand, and that credit availability is broadening on the other.

Exhibit 3: Capital goods orders

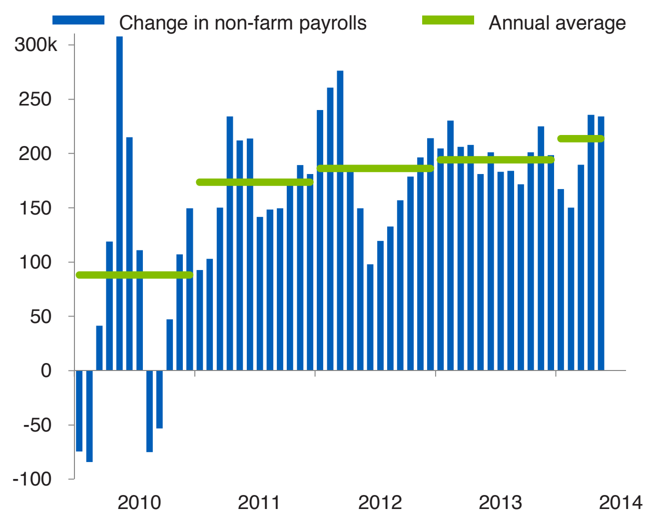
Billions, 3-month moving average, 2006–present



Sources: Haver Analytics and TIAA-CREF Asset Management.
Data as of April 2014.

Exhibit 4: Employment growth

Thousands per month, 2010–present



Sources: Haver Analytics and TIAA-CREF Asset Management.
Data as of May 2014.

The final piece of the puzzle is the continued rise in housing activity. Here, the economy is getting less help. While prices have recovered in many metropolitan areas, activity has not yet recovered to pre-crisis levels. New home construction is a crucial component of economic growth. It drives employment geographically across the country, both directly and at the retail level, by generating activity across many sectors. New home construction leads to a healthy supply chain requiring construction materials and durable goods, and boosts local economies with higher demand for materials, business services and retail sales. Our forecast calls for an annual single family construction rate of 650,000 homes by the end of this year, but that is still less than half the rate seen a decade ago.

Entering the second half of the year, our base case scenario calls for economic activity to rise modestly. Consumers should continue to spend at a marginally stronger pace, and hiring should continue to rise, which will add to overall income growth. Toward the end of the year, business investment will also have strengthened. Housing will continue to improve, but at a much slower pace than last year, and its overall impact on the economy will remain muted. Government expenditures have already tipped to neutral from a drag on growth, and we don't expect any change in that trajectory in coming quarters. Overall, we expect the economy to grow 3.6% during the second quarter, 3.2% in the third quarter, and 3.5% in the fourth.

A growing risk factor to this base case is the burgeoning conflict in Iraq. Since the outbreak in violence over the past few weeks, the price of oil has increased more than 5%, which has already begun to raise prices at the pump. If the conflict escalates further or lasts for an extended period, it could materially raise the price of oil beyond current market levels and significantly lower our growth expectations. We would not become truly concerned about growth, however, unless the price of Brent were to spike through $130 per barrel. In fact, the southern oil fields in Iraq have so far not been affected by the turmoil, and with Libyan production rising, Brent prices may actually decline, which would be very bullish for economic growth.

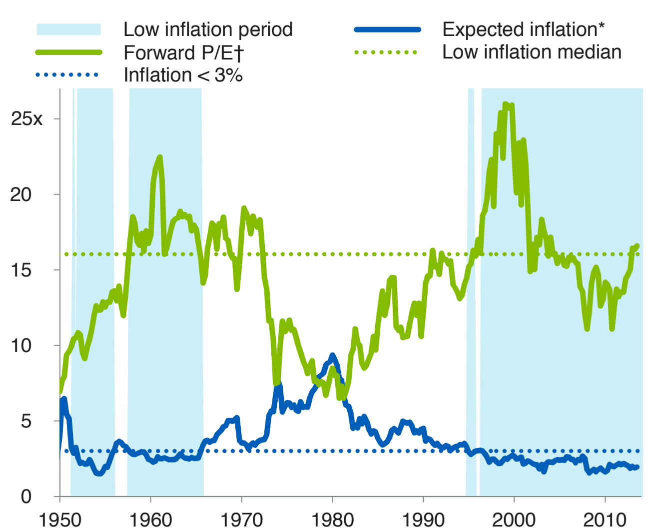
Equities

With the forward multiple (also known as the price-to-earnings, or P/E, ratio) on the Russell 3000 Index having climbed from 10.4 times earnings in 2008 to over 16 times today, some investors are worried about the future potential appreciation of the stock market. The current multiple is about 10% above the median over the last 30 years, and that premium appears excessive to some. We believe, however, that this is the wrong period of comparison, as it includes years when inflation was much higher than it is today. Consensus estimates are for inflation to remain under 3% for the medium term (up to 5 years into the future). Market multiples during post-war periods with similarly low levels of inflation are broadly in line with today's P/E ratio *(see Exhibit 5)*.

In the 1950s and 1960s, P/Es ranged between 10 times and 22 times, with selloffs occurring when multiples approached 19 times. Admittedly, GDP growth was higher during this period, but also more volatile. This suggests that, barring a downturn in the economy or an acceleration of inflation (neither of which we expect), valuations do not pose a threat to further equity gains. Between higher nominal GDP driving revenue growth, and the prospect of cash returning to shareholders through dividends and share buybacks, we believe high single-digit returns for the equity market are achievable in the short to medium term.

Even if the overall market is fairly valued, there is a wide range of multiples across sectors. The hunt for yield continues to benefit utility stocks, which carry a dividend yield of about 3.5% (MSCI USA Utilities Index), compared to just 1.8% for the broad market (MSCI USA Index). Future

Exhibit 5: Russell 3000 forward multiple and U.S. inflation rate

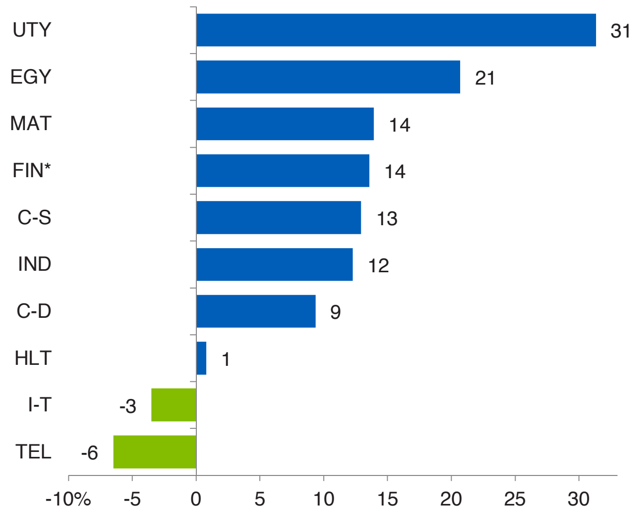


* Expected inflation estimated prior to 1970. † P/E based on actual earnings prior to 1978. Sources: IBES, Survey of Professional Forecasters, BEA, TIAA-CREF Asset Management. Data as of 6/30/2014.

gains for utility shares are likely to be less robust if their valuations (currently around 30% above the median since 1984) normalize along with interest rates *(see Exhibit 6)*.

Exhibit 6: Relative valuations for S&P 500 Index sectors

Current forward multiple compared to median since 1984



UTY = Utilities, EGY = Energy, MAT = Materials, FIN = Financials, C-S = Consumer Staples, IND = Industrials, C-D = Consumer Discretionary, HLT = Health Care, I-T = Information Technology, TEL = Telecom Services. * Excludes REITs. Sources: Standard & Poor's, IBES, TIAA-CREF Asset Management. Data as of 6/30/2014.

The energy sector was the top performer in the second quarter of 2014, as high oil prices driven by repetitive crises in energy-producing countries fed through to equity price gains. Earnings growth expectations have not (yet) kept pace, leading to a multiple for the sector that is well above average. Nonetheless, instability in the Middle East and tension between Russia and Ukraine look set to continue for some time, supporting sustained higher oil prices, which will eventually feed through to earnings. The outlook is for lower multiples as earnings rise, but equity index gains at the recent pace are unlikely. Longer term, increasing domestic oil supplies should produce lower prices and hence lower earnings. Salvation for the industry might then come from exports, but exports on a large scale are still a fairly distant prospect.

Despite being one of the sectors with the highest returns over the past year, health care still has room to outperform others in the market, we believe. The sector rotation that hit the market beginning in February has been beneficial for biotech stocks. Their multiples had become quite elevated, thanks to strong performance since March 2009 (biotech stocks had returned 40% more than the broad market at their peak in February). The subsequent correction has lowered the forward P/E from more than 23.4 times to just 16.7 times today. Demand for new drugs grows unabated, and earnings potential for the sector remains solid, arguing for a continued recovery from April's index low. Other industries in the sector, such as pharmaceuticals as well as health care equipment and supplies, should continue to benefit from the ongoing expansion of the health-care sector in the U.S. Crucially, the pharmaceutical industry has so far been able to prevent pricing pressures from damping profitability.

Fixed income

The Federal Reserve will continue to taper quantitative easing, winding down its bond purchase program through the remainder of this year and putting the Fed on track to begin increasing short-term interest rates toward the end of 2015,

Exhibit 7: U.S. interest rates and foreign exchange rates

U.S. Interest Rates

	Year End (%)	
	2014	2015
Fed Funds	0-0.25	0.25
3-Month Treasury	0.09	0.35
10-Year Treasury	3.00	3.50
Inflation (CPI)	1.9	2.4

Foreign Exchange Rates*

	Period End		
	6/2014	2014	2015
Euro	1.37	1.30	1.25
Yen	101	105	110
Canadian Dollar	0.94	0.95	0.95
Australian Dollar	0.94	0.88	0.92
Brazilian Real	2.21	2.30	2.25

* The Euro, CAD and AUD are priced in currency per USD while the Yen and BRA are priced in USD per currency. Sources: Haver Analytics, Federal Reserve and TIAA-CREF Asset Management. Data as of 6/30/2014.

probably during the fourth quarter *(see Exhibit 7)*. The exact timing of the shift in interest-rate policy will depend on the path of inflation. We do not expect to see much movement in the core PCE index, the Fed's favorite inflation measure. However, consumer prices will begin to move higher this year; indeed, the Consumer Price Index (CPI) has been stronger recently, up 2.1% on a year-over-year basis in May. This measure is volatile, however, and it should settle as the year progresses. We anticipate the CPI gauge will come in close to 2% for the year and close to 2.5% by the end of 2015. Even with modestly higher inflation, we expect the Fed will sit tight on rate hikes until unemployment comes down closer to its longer term average. Thus we would not be surprised to see the Fed overshoot its inflation target of 2%.

The path of longer term interest rates is more difficult to ascertain. History suggests the 10-year Treasury yield should already be above 3%, and the rate at the end of the cycle should be well over 4.5%. However, several factors have kept the long end of the yield curve lower and will continue to do so during this cycle, at least through late 2015 or mid-2016.

One factor has been persistently easy monetary policy around the globe. All major central banks have been in an easing stance for a number of years, and they are unlikely to change course in the next 18 to 24 months.

A major contributor to the unexpected fall in U.S. Treasury yields during the first quarter in particular was the sharp slowdown in U.S. economic growth, precipitated by the harsh winter. GDP contracted by 2.9% in the first quarter, versus an expansion of 2.6% in the fourth quarter of 2013. More recently, Treasuries have benefited from a flight to safety, as geopolitical events in the Middle East and Ukraine have created an undercurrent of demand for Treasuries that would otherwise not exist. This recovery cycle has seen many ups and downs in various economies, as well as regulatory uncertainty across most of the developed world. Collectively, these factors have had the effect of slowing the pace of recovery and keeping Treasury yields low.

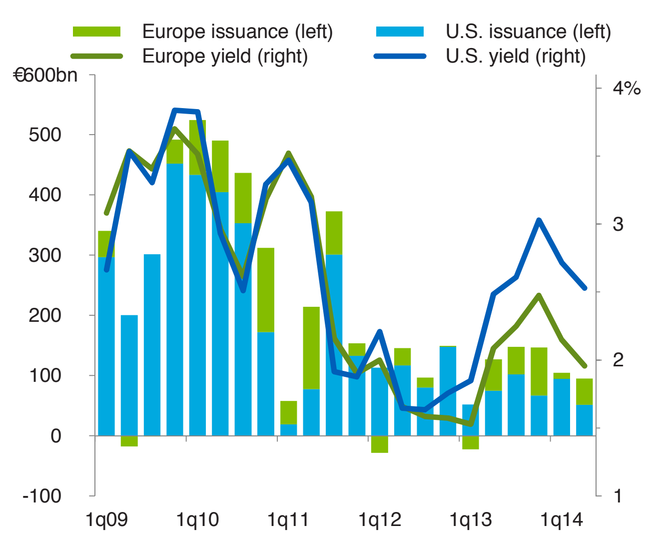
One other factor that has helped lower Treasury yields may prove to be more transitory: namely, a global lack of supply of highly rated debt relative to demand *(see Exhibit 8)*. Net issuance from the U.K. has fallen 36%, from £102 billion in the previous fiscal year to just £65 billion this year. Germany is expected to borrow just €6.5 billion in 2014, less than half the amount it had in the previous year, and it is looking to run a budget surplus by next year. In the U.S., while Fed tapering has increased the supply of Treasuries available to other investors, net issuance has fallen, in part because of a lower federal deficit. (Spending caps since the Budget Control Act was passed have kept a relative lid on the growth rate of federal spending, lessening the need for new Treasury issues.) The fall in agency-backed mortgage issuance of nearly 60% compared to the same period a year ago has added to the supply squeeze.

Even as supply has waned, demand has risen. Regulations in the U.S. are driving banks to increase their holdings of Treasuries, which are at their highest level as a percentage of bank assets since 2000. In Europe, banks are using cheap European Central Bank (ECB) funding to buy higher-yielding sovereign debt. New capital requirements for insurance companies also favor highly rated government bonds.

This imbalance between supply and demand means that yields may not return immediately to the levels warranted by real GDP growth and inflation. Once banks and insurance companies have buttressed their balance sheets, however, marginal demand will decline. Even as Germany moves to a budget surplus, the U.K. forecasts net bond issuance rising by 40% next year (though it declines afterward). The U.S. budget deficit has shrunk from nearly 10% of GDP in 2009 to an estimated 2.8% this year, but the Congressional Budget Office anticipates it will remain around 3% for the next several years. Consequently, the excess demand pressure on bond yields should weaken over the next six months.

Moreover, an improving U.S. economy and rising inflation will eventually cause rates to rise. The question is when and by

Exhibit 8: Issuance of sovereign debt and yields for U.S. and select AAA-rated European countries



Note: European issuance is for Germany and the U.K. Sources: Sifma, U.K. Debt Management Office, Deutsche Finanzagentur, TIAA-CREF Asset Management. Data as of 6/30/2014 except for debt issuance through May 2014.

how much. The resumption in GDP growth that we are now seeing in the second quarter is already reflected in slightly higher Treasury yields, which have bounced off May's low of 2.44%. Based on the above factors and better communication by the Fed in recent months, our models suggest the 10-year Treasury yield will hit 3% by year's end and rise slowly through 2015 to end the year at about 3.5%. If the path of inflation is stronger than we expect and the Fed decides to allow inflation to overshoot its target, we could see the 10-year yield rise more than our forecast during the second half of 2015.

Treasury inflation-protected securities (TIPS) have benefited this year along with Treasuries, as yields, rather than inflation expectations, have been the key driver of returns. If our forecast for Treasury yields proves accurate, the outperformance of TIPS so far this year will reverse, as these securities generally have longer durations, making them more vulnerable to rising interest rates.

Municipal bonds have rallied strongly over the past six months, and yields now are just 50 basis points above all-time lows. Nonetheless, prices look well supported for the time being, as municipalities are reluctant to issue new debt, focusing their slowly recovering revenues on restoring services that were cut during the recession, or on paying into underfunded pension pots. Municipal financials are improving along with property and sales taxes, so the risk of an increase in credit spreads remains low.

The other fixed-income asset classes that we have favored so far this year — namely high-yield corporate bonds and residential mortgage-backed securities (RMBS) — remain attractive (at least compared to the alternatives), with leveraged loans a good hedge against rising interest rates.

Europe

Economy

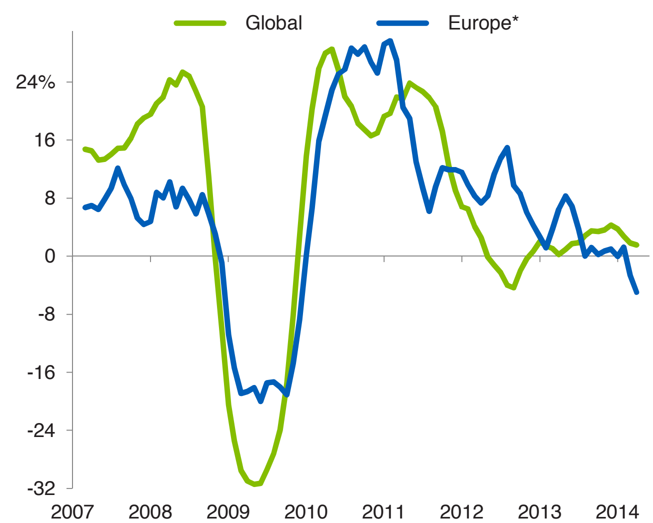
Europe exited recession in the fall of last year and has steadily advanced since then. The negative impact of regulatory reform on the economy continues to diminish, reducing headwinds. Growth on the continent has accelerated from close to -0.5% last year to about 1% this year. While not spectacular, this 1.5% swing is helping shift the economic dynamic around the globe. Beyond better domestic conditions, better growth in Europe provides support for the export sector in many countries, including the U.S. At the same time, the ECB has entered a new easing phase, lowering borrowing rates and initiating a new Long Term Refinancing Operation (LTRO), both of which will provide further liquidity to markets and encourage lending growth. While Germany's economy continues to do much of the heavy lifting in the eurozone, the peripheral countries are also seeing improvements this year. Labor market conditions are strengthening in Spain, Italy, and even Greece, while capital costs are declining across the continent, and sovereign finances are firming.

Equities

Equity markets nonetheless face challenges. European corporations continue to be dogged by relatively lackluster economic growth, rigid labor markets (which hinder their ability to reduce costs), and subdued worldwide trade. European Union (EU) exports have underperformed the rest of the world, declining sharply over the last two months *(see Exhibit 9)*.

Exhibit 9: Merchandise exports growth

Year-over-year



* Europe exports are extra-EU. Sources: WTO, TIAA-CREF Asset Management. Data through April 2014.

As a result, earnings expectations remain low for the region as a whole, with practically flat growth forecasted over the next twelve months. There are opportunities below the surface, however. Even though the euro was intended to harmonize the economies of the region, there still remain significant differences between countries. These are all the more evident now that debt levels and productivity have diverged. The key strengths of German companies, namely labor cost control and strong export prowess, mean that earnings have grown steadily and kept valuations in line. Though the country's market is unlikely to post outsized returns similar to some of those in the periphery, particularly as it is a large market unloved by its own domestic investors, it offers the prospect of steady gains in the near future. More generally, countries in the "core" of Europe have been able to maintain earnings growth expectations (albeit at half the rate of the U.S.), while the periphery continues to struggle *(see Exhibit 10)*.

The U.K. market has been dragged down by a strengthening currency versus both the dollar and the euro (gains of 14% and 9%, respectively, since last summer). The rising pound has offset the boost provided by the strongest economic growth in the region. Nonetheless, U.K. equity returns have been modestly positive, as the index has closed a valuation gap of 10% over the past year. With the prospect of interest rates rising in the U.K. sooner than in any other major developed market, the pound is likely to remain strong, and the equity market may continue to struggle relative to other European countries.

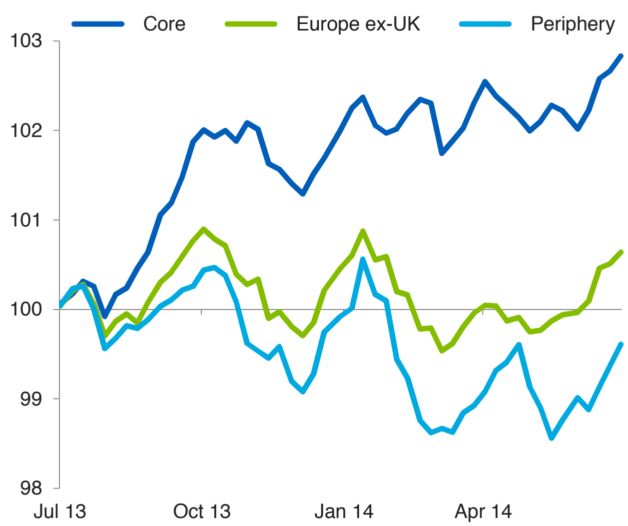
Fixed income

Persistent efforts by the ECB to maintain low interest rates in the eurozone have led to healthy returns for sovereign and corporate debt over the last year. This same persistency, however, means that future returns are likely to be much more subdued. Yields on 10-year Spanish government debt briefly fell below those on U.S. debt despite Spain's rating of BBB vs. AA+ for the U.S. Low Spanish yields reflect weak GDP growth and inflation under 1% rather than credit risk, which the market has determined is minimal given the ECB's commitment to purchase sovereign debt if it ever needs to. Spreads relative to Germany, however, remain high for the euro era, suggesting peripheral government debt is likely to outperform that of core governments *(see Exhibit 11)*.

European sovereign and corporate debt is also likely to provide higher returns than its U.S. equivalents. Yields are higher in the U.S., partly because durations are longer, but interest rates are more likely to increase in the U.S. as the Fed slowly tightens monetary policy while the ECB looks for ever more creative ways of loosening it. European high-yield spreads are slightly narrower than those for U.S. high yield, while the credit risk is arguably higher. Baseline expected default are nonetheless comparable to those in the U.S. (according to Moody's), so the approximately 300 basis-point spread seems attractive on a risk-adjusted basis.

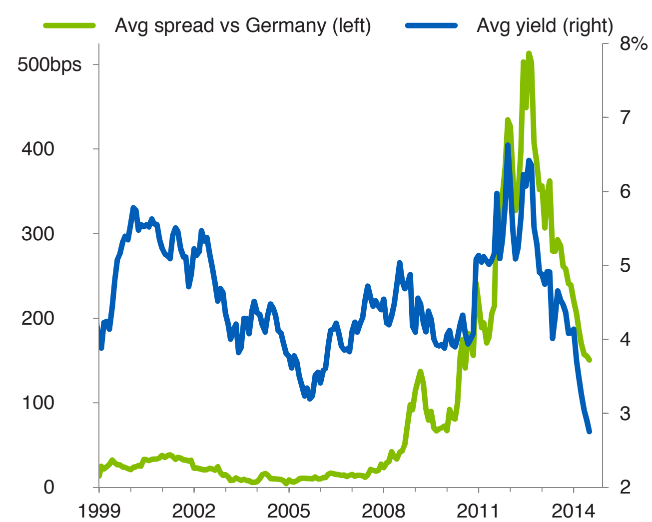
Exhibit 10: Equity earnings growth expectations

Next 12 months EPS. 6/30/2013 = 100



Note: Core = Austria, Belgium, Finland, Germany, Netherlands; Periphery = France, Greece, Ireland, Italy, Portugal, Spain.
Sources: IBES, TIAA-CREF Asset Management. Data as of 6/30/2014.

Exhibit 11: Spanish and Italian sovereign debt



Sources: Bloomberg, TIAA-CREF Asset Management.
Data as of 6/30/2014.

Japan

Economy

"Abenomics," Prime Minister Shinzo Abe's three-point plan to jumpstart Japan's economy and exit the country's liquidity trap, has been largely successful so far. However, more time is required to determine whether it will ultimately succeed or fail. The foundation of Abenomics is historically easy monetary policy. By engaging in a massive quantitative easing program, the Bank of Japan (BoJ) is hoping to stimulate domestic demand, investment, and inflationary expectations, while simultaneously keeping long-term interest rates at historical lows, which will help support increased government spending—the second building block of the program.

Japan's economic performance was strong in the first quarter of 2014, at a 6.7% annualized rate. Much of this growth was simply demand pulled forward because of a 3% VAT (Valued Added Tax or sales tax) increase that took effect on April 1. Consequently, the second quarter will give some growth back; we estimate a 5% pullback for the three months ended June 30. But beyond the near-term tax dynamics, the economy continues to improve, with gains seen in consumption, investment, and wages, along with positive inflation expectations. The second half of the year has a good chance of producing growth rates in the mid-2% range, with a consistently stronger positive inflation rate—something not witnessed in a number of years.

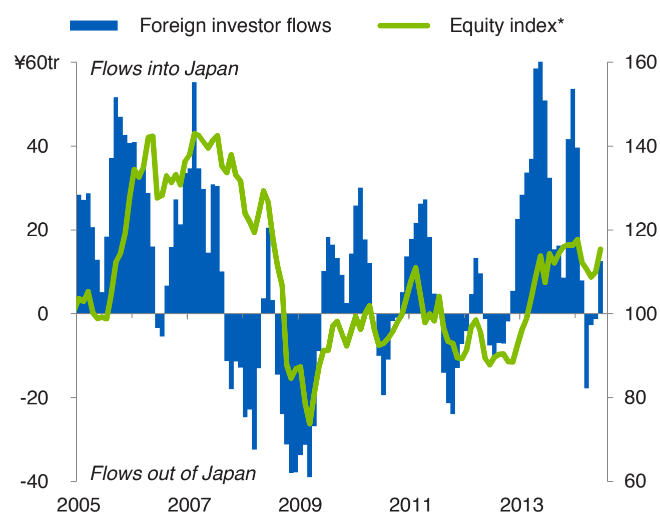
Equities

Japan's equity market rallied at the end of the second quarter, beating the Kokusai Index (developed markets ex-Japan) as investors signaled approval of Abe's latest reform initiatives. Foreign flows into Japanese equities have turned positive again following, reversing heavy redemptions earlier in the year *(see Exhibit 12)*. Importantly, the market's gains occurred despite the yen holding tightly to an exchange rate of ¥102/$.

Whether this outperformance proves to be sustainable is still highly dependent on government actions, either on the Abe administration pursuing its reform agenda more aggressively, or on the Bank of Japan doubling down on quantitative easing. Further action by the BoJ is not imminent, as it waits to evaluate the impact of the consumption tax hike (VAT) on consumer demand. The steady currency, however, means that earnings growth expectations have flattened, and underlying corporate profitability has not yet improved.

New measures unveiled by Abe on June 24 emphasize reducing corporate taxes, strengthening corporate governance, and addressing structural problems in labor markets and the agriculture sector. While the proposals are inevitably not as broad or deep as investors might like, the outlook is still for incremental improvement in the economy. The prospect of lower taxes and passage of a law to legalize casinos should give a renewed boost to sentiment. Given the equity market's low return on equity (8.7% compared to 14.1% for the Kokusai index) and low valuation (a 12% discount to average multiples compared to a 14% premium to the Kokusai), money invested today should nonetheless benefit from Abe's initiatives.

Exhibit 12: Foreign and domestic Japanese investment in the Japanese equity market



* Index in U.S.-dollar terms. Note: Flows are three-month rolling sum.
Sources: Japan Ministry of Finance, TIAA-CREF Asset Management.
Data as of 6/27/2014.

Emerging markets

Economy

Emerging market countries (excluding China) can be broadly split into three categories: those with a balance of payments deficit, those without, and Central and Eastern Europe (CEE). While the slowdown in the commodity cycle has temporarily cooled many emerging market economies, those with a balance of payments deficit are more susceptible to currency and interest rate swings, which tend to accompany changes in commodity prices and shifting global growth. In the CEE region, growth has stabilized; however, the region's proximity and economic ties to the EU bloc will also likely necessitate easier monetary policy in several countries, in accordance with the recent moves by the ECB.

China stands in a category of its own. It is largely responsible for the global shift in commodity demand, being the marginal purchaser of many marketable commodities in recent years. However, the new administration has shifted emphasis away from industrial growth and urbanization toward softer targets: raising the living standards of those in rural areas; developing education, sanitation, and pollution infrastructure; and improving the country's legal and regulatory institutions to allow for liberalized financial and foreign exchange markets, as well as broader economic connections, to the rest of the world.

While near-term economic growth has slowed with this shift in emphasis, China's long-term growth rate must also come down based solely on the growing size of its economy. This year we expect China to grow just over 7%. The first quarter came in at a 5.9% annualized rate, but the second quarter will likely see stronger growth because the central bank has lowered interest rates to stimulate activity, while the government has increased fiscal spending. We also expect the economy to stabilize during the third and fourth quarters, with growth rates in excess of 7%. One concern in China is soft real estate prices, which have fallen in recent months. A continuation of this trend could slow aggregate growth below our forecast.

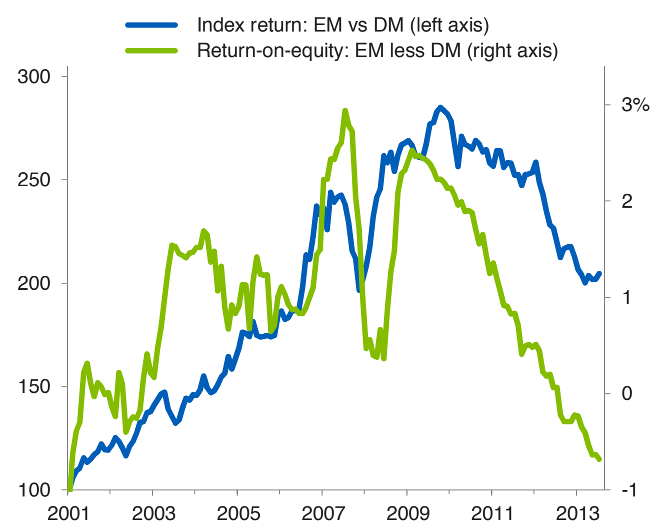
Equities

Emerging market equities have recently faced challenges on several fronts:

- The Russian-Ukraine dispute threatens growth in neighboring EMEA (Europe, Middle East and Africa) markets.
- In Brazil, despite World Cup enthusiasm, government intervention remains a barrier to large-cap equity performance.
- In Mexico, while the outlook for liberalizing parts of the market is strong (particularly in energy), the sectors dominated by incumbent monopolies will suffer as they face competition.
- In Chile, the new president's economic agenda is less friendly toward business than that of her predecessor.
- Most importantly, in China, managing a slowdown in the property market will require adept pulling of all the government's levers.

Despite these challenges, investor sentiment may have finally swung again in favor of emerging markets — fund flows have returned to the asset class after several months of redemptions. Relative equity index performance has nonetheless improved recently, although this is partly due to the strengthening of emerging market currencies against the U.S. dollar. The key driver of the swing in sentiment and performance may simply have been valuations, as the discount of emerging markets to developed markets (ex-Japan) had fallen to its lowest level since 2005. Valuations can rise either through price appreciation or through earnings depreciation, and earnings growth remains the key challenge for the asset class. While earnings are recovering across most global equity markets, they have not recovered as quickly in emerging markets as in developed markets. Consequently, the relative profitability of emerging market companies has lagged that of their developed market counterparts *(see Exhibit 13)*.

Exhibit 13: Relative profitability and index returns, emerging vs. developed markets



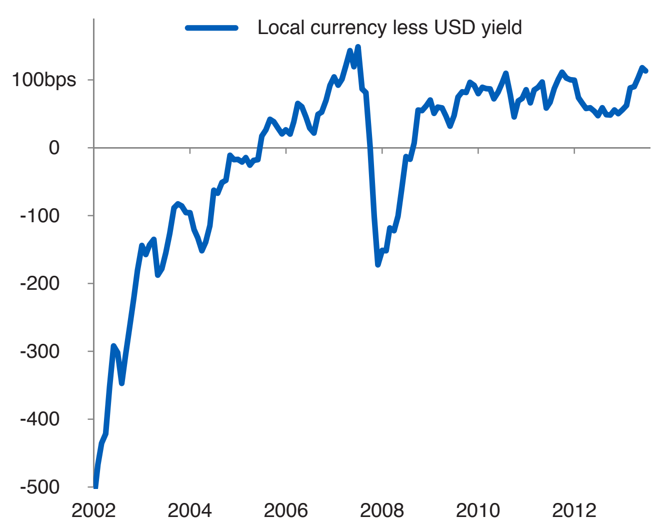
Data as of 6/30/2014. Note: ROE based on next-twelve-month consensus estimates. Sources: IBES, TIAA-CREF Asset Management.

Sustained outperformance of emerging market equities will require a change in this pattern. Consequently, short-term returns in emerging markets may disappoint, but we believe this may still be an opportune time to begin overweighting the asset class, as performance further out should prove to be stronger.

Fixed income

Spreads of emerging market U.S. dollar-denominated (USD) debt versus developed market debt, both for sovereigns and corporates, remain high at just under 200 basis points. Neither the Russia-Ukraine standoff nor the turmoil in Iraq has significantly changed investor perceptions of emerging market risk, so this spread appears attractive. Yields on emerging market sovereign USD debt are nonetheless low, especially compared to debt issued in local currency by emerging market governments. This spread turned negative in 2008 and 2009 as USD debt was an easy source of liquidity for fleeing foreign investors, but today the spread is over 100 basis points, near historical highs *(see Exhibit 14)*. Although there is some risk of emerging market currency depreciation eating into returns if there is a replay of last year's "taper tantrum," the extra yield is welcome given the paucity of alternatives.

Exhibit 14: Emerging market debt yield spread



Sources: JP Morgan, TIAA-CREF Asset Management.
Data as of 6/30/2014.

Conclusion

Typical recoveries after typical recessions are robust, but they entail greater risk of subsequently overshooting and prompting another turn in the business cycle as central banks hike interest rates to contain inflation. The virtue of this recovery is that it has been steady and resilient (the first quarter of this year notwithstanding). Growth may be disappointing, but the recovery should continue accelerating slowly and looks to last for some time.

This is positive for equity markets, which have recovered from the trauma of the financial crisis. Nervous investors, perhaps, have not, as they fixate on the length of the market rally, low volatility, or supposedly high valuations, as warnings signs of an impending correction. We believe the better attitude is to keep calm and let the market carry on. It is true, however, that outside of emerging markets valuations are no longer compelling by themselves and some parts of the market appear expensive (high-dividend-yielding sectors and small cap, for example). In a low inflation/low nominal GDP environment, future earnings growth will come from those companies that can manage costs and improve productivity. This drives our preference for high quality, larger capitalization stocks.

The challenge of maintaining positive returns in fixed income remains, even as the timing of the eventual reckoning — when yields return to long-run averages — is uncertain. Investors still need to accept lower returns for more risk, but they should not become complacent about the eventual consequences of that trade.

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