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Separating the wheat from the chaff

It is often claimed that when the US sneezes, the rest of the world catches a cold. But what if the US is shivering because emerging economies like China are buying all the fuel? The US might be less important than many people think because a lot of analysis focuses on the late 1990s when domestic demand imploded in Asia and Russia. These days, a low cost of capital is boosting domestic demand in emerging economies, boosting commodity prices and squeezing profits and real incomes in the US. Eventually, inflation pressures should force emerging economies to 'de-peg' their exchange rates, leading to a similar underperformance of US and UK assets that we saw 40-years ago following the breakdown of the previous fixed-exchange rate regime, Bretton Woods.

We've all heard the cliché about the rest of the world catching whatever illness the US is afflicted with. Markets seem to believe it. The German DAX index has fallen more this year than the S&P500, even though German business confidence has unexpectedly risen for three consecutive months. It's all about lags you see. Another analogy commonly used is 'Road Runner'. The German economy is still running but eventually it's going to look down and realise it has run off the edge of the cliff and will inevitably crash down. That's

why consensus GDP growth and earnings forecasts are stronger for the US in 2009 than the euro area. Looser monetary and fiscal policy will see the US economy recover at the same time as the euro area economy slows.

While this scenario is possible, it could also prove lazy. When we look at the world we still see an economy that is growing at above trend pace (Figure 1). The world is not just the US (which we believe will enter a deeper recession than consensus expects). It also includes

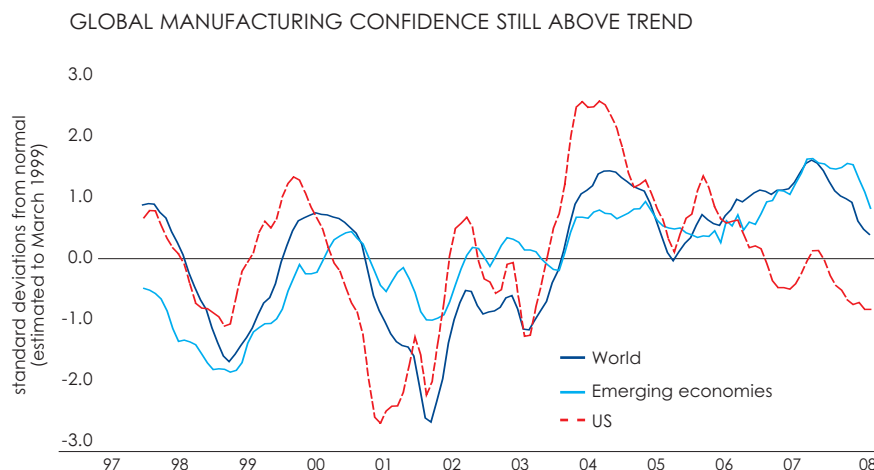


Figure 1

Source: LGIM Estimates, Reuters Ecowin

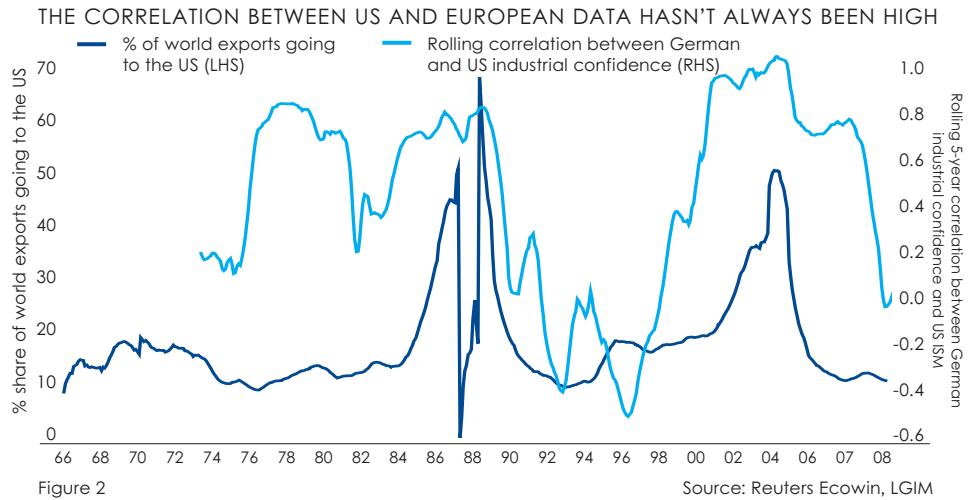
economies such as Brazil, Russia, India, China, South Africa and Turkey. When we include these economies, global manufacturing confidence is still above trend as credit growth is booming. With capacity shortages growing more extreme and the Fed reducing the global cost of capital, demand for investment equipment from European factories remains strong.

It is often claimed that emerging economies are investing merely to produce more goods for export to the US consumer. So as the US consumer slows, investment in emerging economies will inevitably follow. But we believe emerging economies have benefited more from importing a low cost of capital from the Federal Reserve than they have by exporting goods to US consumers. For all the talk of a world dependent on the US consumer, Chinese vehicle sales have grown from 10% of those in the US in 1998 to around 66% now.

We believe emerging economies will inevitably slow down, but for a different reason than many expect – inflation not exports. Our analysis suggests commodity prices are driven by emerging economies rather than the US. Eventually, policymakers in emerging economies will be forced by domestic political reasons to curtail credit by de-pegging their exchange rates and setting independent monetary policy. This should lead to further underperformance of US assets, just as we saw 40-years ago when the Bretton Woods fixed-exchange regime broke down.

History

For those of us who can't remember back then, it's worth reviewing the economic data over the past forty years. In particular, the importance of the US economy and the correlation between US economic data and the rest of the world. In Figure 2, we plot the rolling five year correlation between US and German business confidence against the



5-year average share of global exports going to the US. In the late 1990s, almost 50% of global exports went to the US. So unsurprisingly there was an almost perfect correlation between US and German confidence. But over the past five years, only 10% of global exports have gone to the US and the correlation between US and German confidence has turned negative. Most significantly, this is not unusual. We saw the same thing in the early 1990s and to a lesser extent in the early 1980s and 1970s. In other words, the US has not always been as important as many believe.

Most analysts focus on the experience of the late 1990s. Understandably perhaps as that's the most recent business cycle and it's harder to get economic data going further back. But we believe late 1990s trade flows are distorted by the collapse of the Soviet Union in the early

1990s and the Asia crisis, because demand was imploding in emerging economies, Germany had nowhere else to export to apart from the US. But that's different now. Domestic demand is booming in emerging economies, so Germany's exports are more spread out. In fact, over the past five years, Germany's exports to the US in euro terms have not risen at all, but that hasn't prevented total exports rising more than 50%.

There are a lot of similarities between today and the early 1990s. Back then, the savings and loans crisis depressed the US economy, but Germany continued to boom as money was poured in to rebuilding Eastern Germany. Only things are on a bigger scale this time. Instead of Eastern Germany, it's Eastern Europe, Russia and Asia. And because the world is rebuilding, commodity prices are buoyant, boosting incomes and demand in the Middle East, Latin America and Africa.

DOMESTIC DEMAND HAS RE-ACCELERATED IN EMERGING ECONOMIES

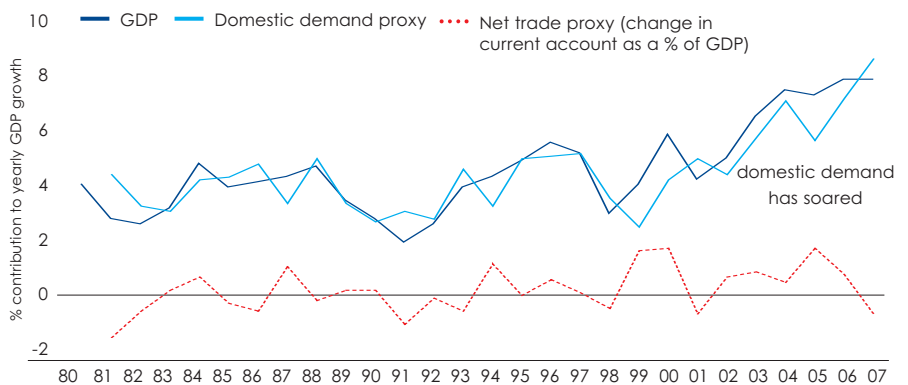
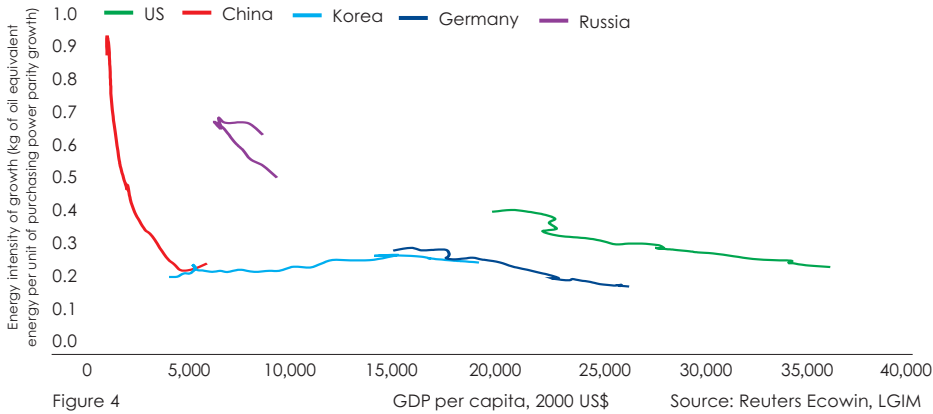


Figure 3 Source: Reuters Ecowin, LGIM

CHINA'S ENERGY INTENSITY IS INCREASING



Of course, Germany did inevitably enter into a recession. But it was arguably caused more by the Bundesbank raising interest rates to combat inflation – exacerbated by the spike in energy prices and uncertainty following Iraq’s invasion of Kuwait – than the US banking crisis. We wouldn’t be surprised to see a severe economic downturn in emerging economies over the coming years. But we believe it will be caused by domestic policy tightening depressing growth rather than weaker exports to the US.

Figure 3 helps illustrate why. It decomposes the increase in GDP in emerging economies over recent years into domestic demand and net exports. Our calculations suggest 90% of the growth in GDP has been driven by stronger domestic demand. The reason for this is the sharp compression in emerging market bond spreads as weak US equity markets and low Treasury yields encouraged investors to ‘search for yield’. While US corporate debt spreads are at recessionary levels, emerging-market bond yields remain historically low and, crucially, below the long-run rate of return. For example, Russian government bond yields are currently just 5.5%. This compares with a peak of 75% in 1998 following its default. Over the past five years the Russian economy has grown in cash terms at an average rate of 25%.

With the cost of capital so low, it’s unsurprising that credit in emerging economies is booming. In US\$ terms, it’s currently growing by 27% year-on-year, the fastest rate of increase since 1995. In our view, this helps explain the buoyancy of commodity prices.

Our analysis suggests emerging economies, not the US, drive energy prices. This is despite the fact that the US economy is the most energy hungry economy in the developed world. In Figure 4 we plot the relationship between income (x-axis) and energy consumption per dollar of growth (y-axis) across time for different countries. Most curves are sloping downward, suggesting countries become more energy efficient over time as technology improves and they move from being a manufacturing economy to a service one. You can see straight away that it takes 50% more energy to produce a

dollar of growth in the US than it does in Germany, implying a US recession will curtail energy demand.

But if you look at the left hand side of the chart, you can see that Russia uses twice as much energy as the US does per unit of growth. China uses similar amounts to the US. But what is most striking is that China’s energy intensity has actually picked up in recent years. It might be following the path of Korea. Namely, as incomes rise, households use more energy as they buy their first car for example.

We have calculated a measure of global energy demand (Figure 5). It is the increase in GDP in each economy adjusted for the energy intensity of growth. This series has soared in recent years, driven by emerging economies and coinciding with double-digit commodity price gains. Our economic forecasts, which are far gloomier than consensus on the US, are still consistent with buoyant commodity prices. In fact, we would argue that buoyant commodity prices are helping to push the US economy into recession by depressing household spending power and corporate profits.

We believe that demand for energy is outstripping supply. This can be seen in Figure 6. Over the past twenty years, the growth of energy supply has not changed even though energy demand has accelerated. We believe this is

BUOYANT DEMAND HAS DRIVEN UP COMMODITY PRICES

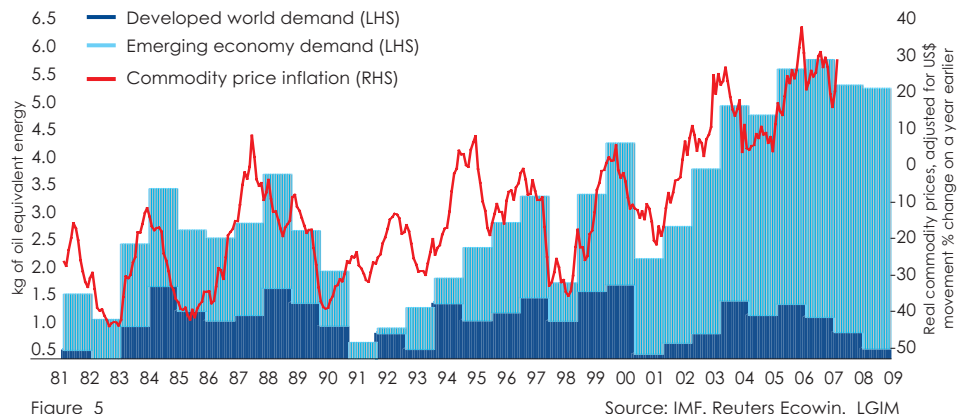


Figure 5

Source: IMF, Reuters Ecowin, LGIM

ENERGY DEMAND IS OUTSTRIPPING SUPPLY

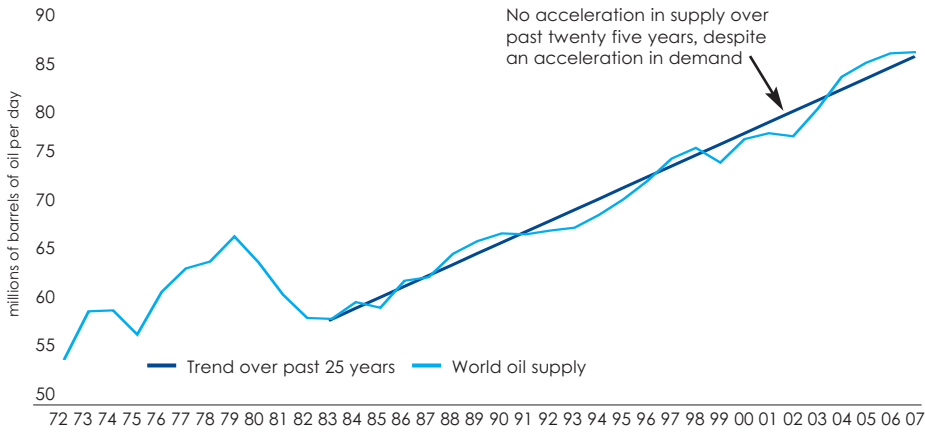


Figure 6

Source: Reuters Ecowin

spilling over into food prices. 20% of US agricultural land is now taken up by biofuels, up from just 3% in 2000.

In simple terms, during the 1990s the world's resources were shared unevenly. US living standards rose sharply as consumers benefited from cheap energy and manufactured goods as a series of crises rippled from Latin America to Asia to Russia. Not only was the global economic cake increasing, but the US was getting a bigger slice. We believe those days are gone. The global cake is still expanding at a trend-like pace, but the US's share is shrinking. It is important to differentiate between the two effects.

Former and current communist countries such as Russia and China have liberalised their economies, becoming more productive and richer in the process. So it's unsurprising that they are consuming a larger share of the world's resources. With global demand outstripping supply, some economies need to slow. History tells us that it's always the biggest debtors that slow. That means the US and the UK today, just as it was Russia, Asia and Latin America in previous decades.

The question is timing. The danger is that emerging economies are repeating the mistakes the West made 40-years ago. They are trying to tackle rising food

and energy prices by freezing prices and increasing infrastructure investment. But pegging their currencies to the dollar means that monetary policy remains too loose. A global inflationary boom in 2009 seems just as likely as a deflationary bust.

Neither scenario is good for financial markets. Inflation today just signals a recession tomorrow. Thankfully, equity markets seem to be more appropriately valued now than in 2001. They appear to be discounting a sharp slowdown in earnings over the next few years. Unfortunately, markets often overshoot. The equity risk premium tends to increase when inflation rises and profits fall. Both developments seem likely over the next year. So we remain cautious on both equity and bond markets.

The strongest call is on relative performance. The 1970s was a terrible time for risky assets. Neither German nor US equity markets grew in local currency terms. But in US\$ terms, German markets performed much better as the dollar collapsed. We seem set for a repeat over the next decade. In general, European and emerging economy assets should outperform US and UK assets in sterling terms. Countries with large current account surpluses and are net commodity exporters should do particularly well. Even if the global economic cake grows at a slower rate than before, at least those economies will be getting a larger slice.

GERMAN ASSETS PERFORMED MUCH BETTER THAN US ONES IN THE 1970'S AS THE DOLLAR COLLAPSED

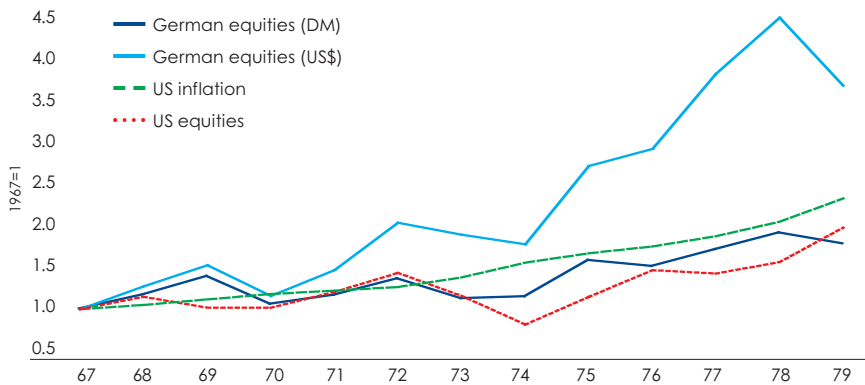


Figure 7

Source: ABN Amro

Market Overview

Bear baiting

Global equity markets continued to deteriorate in March, but there have been some positive developments. The Federal Reserve has taken significant action to stabilise financial markets. Not only has it cut interest rates aggressively but it has also engineered a takeover for Bear Stearns. Recent US economic data have been weak in absolute terms, but not as weak as expected, suggesting a recession is widely expected now. Moreover, in coming months the US economy should benefit from tax cuts. If this were to help stabilise economic data, market sentiment could improve from current depressed levels, triggering a bear-market rally.

At the same time we expect to see continued weakness in UK economic data. The Bank of England has cut its base rate in recent months but mortgage rates have not come down as lending standards have been tightened. So households have not seen any benefit. Indeed, house prices are falling, undermining consumer sentiment. While a weak pound should support exports, a collapse in construction activity should push unemployment higher.

London

Continued consumer concern

The UK equity market posted a negative return of -2.1% in March. Mid caps outperformed the broader market although they still produced a negative total return of -0.2%, whilst small caps lagged (-5.8%) and large caps performed in line (FTSE 100 -2.2%). The prospect of an economic slowdown coupled with the ongoing credit crisis continued to dominate investors' thoughts. Not surprisingly, consumer cyclical sectors such as Retail and Leisure remained under pressure whilst more defensive sectors such as Food Producers, Electricity and Tobacco all posted gains. Financials also rallied on attempts by the authorities to resolve the liquidity crisis in the Banking sector. Mining saw some profit taking after the collapse of takeover talks at Xstrata. Elsewhere, British Energy confirmed it had received a bid approach. We expect markets to remain volatile in the short term with increased evidence of slowing consumer spending and difficult credit markets constraining corporate profits.

Wall Street

Bear market

The S&P 500 was down -0.6% in March and a negative -10% in the first quarter. Information technology, financials and telecom services were the worst performing sectors over the quarter.

We saw a broad based deterioration in economic and earnings data in March. Unemployment continued to rise and consumer sentiment surveys hit multi-decade lows. Home foreclosure trends showed further deterioration and home prices continued to decline.

Credit conditions improved following the 75bps Fed rate cut and the implementation of a special lending facility for non-bank financial institutions. This improvement came too late for Bear Stearns which was bought by JPMorgan Chase for a price far below its value.

S&P 500 first quarter earnings growth expectations were slashed to negative -9% from +6% at the start of 2008. Excluding Financials, earnings are expected to grow +9.6% during the first quarter. There was further bad news from the consumer sector as J.C. Penny lowered its sales guidance to account for significantly lower consumer traffic.

The outlook for equity market remains challenging. Profit estimates for 2008 are likely to be reduced and the ongoing correction in consumer activity is likely to dampen the growth outlook.

MAJOR EQUITY MARKETS – TOTAL RETURNS £ 2007/2008

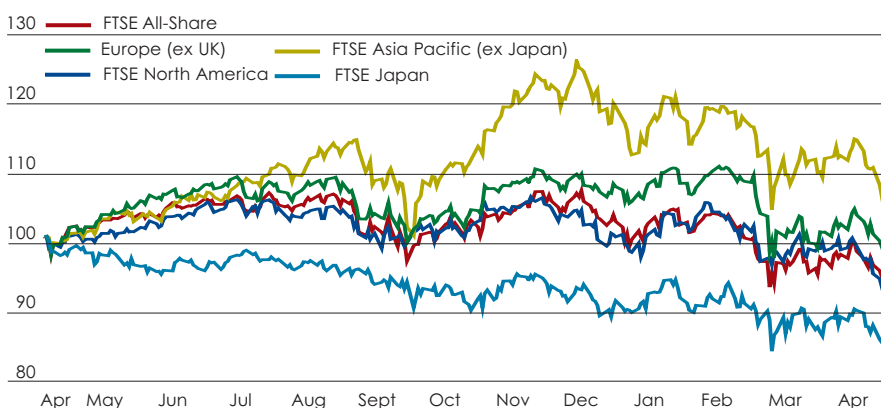


Figure 1

Source: Datastream

MAJOR WORLD BOND MARKETS – TOTAL RETURNS £ 2007/2008

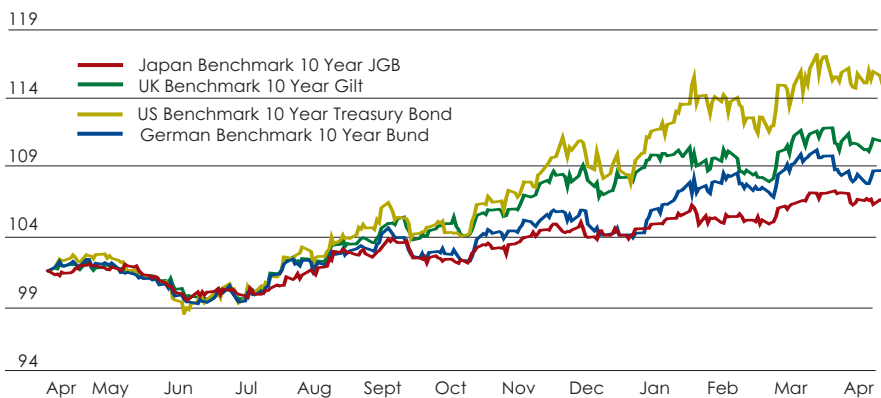


Figure 2

Source: Datastream

Europe

UBS rights issue

Moderating growth and increased inflationary pressure remain the twin economic themes across Europe. The combination of both sent markets lower in March before rallying towards the end of the month. The resilience of financial stocks, however, has been surprising, since it was in this sector that the current economic problems originated. As balance sheet repair continues amongst the banks there is a growing perception that, in spite of the ECB's intransigence, the Fed will do all it can to ease strains in US asset markets, and that perhaps the worst of the asset impairments within the sector is past. Many are pointing to the announcement of UBS' fifteen billion Swiss franc rights issue as a watershed moment, potentially drawing a line under the worst of the problems at the European bank most exposed to the fall-out in US asset markets. If this is genuinely the case, the rally in financial stocks may continue, owing to the perception that the stocks offer attractive value, provided there are no further write-offs to be made.

If financial stocks continue their recovery, they should lead the market higher. Companies across Europe are suggesting that underlying demand has moderated, but remains positive. This should bode well for reasonable, but not exceptional, earnings growth over the balance of the year. There are clearly headwinds, in the form of higher raw material costs and, for those companies with meaningful earnings in US dollars, a strong European currency and weak US demand. It is also true that, whilst a global liquidity crisis has not turned into a global solvency issue, the problems of the global banking system will take some time to work through. Ultimately, the sector will see only

moderate underlying growth at best, tighter regulatory control and reduced risk budgets. In the industrial sectors we expect anaemic growth, and continue to focus on companies with some insulation from the developed world economic cycle, and who are also able to pass through higher input costs.

Japan

No governor

During the first half of the month the Topix index fell as the yen strengthened against its peers, renewing fears that companies will report poor earnings during the forthcoming results season. A deterioration in US employment data added to bearish sentiment as the US market continued to lead the Japanese market down. From 17 March global markets rallied following the \$2 per share offer for Bear Stearns by JPMorgan and the Federal Reserve; many investors saw this event as marking the bottom of the bear market. As a result equity markets rallied, led by financial stocks.

The Bank of Japan Governor debacle continues with the Lower and Upper House unable to agree on a suitable successor to Fukui-san. The downward revision to the October – December quarter GDP reading came in smaller than expected, showing very bullish annualised growth of 3.5%.

As we enter into full year earnings season in Japan, investors are bracing themselves for poor results and even poorer forecasts as a result of the stronger yen and the deteriorating economic environment. We anticipate that the Bank of Japan governor will be appointed in the forthcoming month, but do not expect this to have any significant impact on policy making. We will

continue to watch the newsflow out of the US as signs that the credit crunch has started to impact consumer spending appear, with JC Penny forewarning the market of a probable decline in retail sales for the February – April period.

Pacific Basin

Taiwan - Chinese relations take off

The FTSE World Asia Pacific (ex Japan) & index fell -3.8% in March. Asian markets have remained volatile as investors have become more risk averse worrying about the robustness of earnings growth, given fears of a US recession and its potential negative impact on the world economy. The leading markets were Taiwan (+2.9%) and Singapore (+1.3%), the only markets in positive territory. Under-performers included China (-12.6%), Indonesia (-2.0%), India (-1.0%) and Malaysia (-7.7%).

In Taiwan Ma Ying-jeou of the Kuomintang party (KMT) achieved a 17 point winning margin, giving him a strong mandate to fully execute his economic program of closer economic ties with China. Charter flights are expected to start in the third quarter of 2008, providing easier access for mainland Chinese visitors. Singapore outperformed as financials have clarified their lack of exposure to sub-prime issues in recent results.

In China, escalating food prices pushed up February's CPI to an 11 year high of +8.7% year-on-year. The PBoC announced that the reserve requirement ratio will be raised by 50 bp to +15.5% on March 25. In Malaysia the General Election result was a shock result. Although the coalition government led by Barisan Nasional (BN) managed to hold on to power, their majority was greatly reduced. BN won 137 seats, short of the two thirds majority in Parliament. Furthermore they lost five states to the opposition, the worst showing in an election since independence in 1957.

Global markets will remain volatile as the consequences of the credit crisis come to light. Against this environment, however, the Asian (ex-Japan) region should remain relatively resilient. Consumption and investment growth, coupled with intra Asian trade, will continue to offset weakness in export demand from Western countries. Following the recent falls some of the companies in the region are also now at attractive valuations.

Snapshot

Mortgage resets

There is considerable concern that although the Bank of England has cut its base rate by 75bp over the past six months, households aren't seeing the benefit because mortgage rates are still rising. This reflects an elevated 'risk premium' between the Bank of England's base rate and the rate at which private-sector banks are willing to lend to each other.

Some of the worst fears about rising interest rates for homeowners might be overdone. Most of the increases in mortgage rates appear to be for new – rather than existing – customers. The Bank of England calculates effective interest rates paid by households based on interest payments and the amount of debt outstanding. Between August 2007 and February 2008, the rate of interest paid on the stock of floating rate mortgages fell by 35bp (Figure 1). But with only 50% of mortgages on floating rates, the total effective interest rate paid has fallen by just 10bp from its peak. This is because fixed rate mortgage rates have continued to creep up. But at least on an aggregate level, interest rates are coming down, if only gradually.

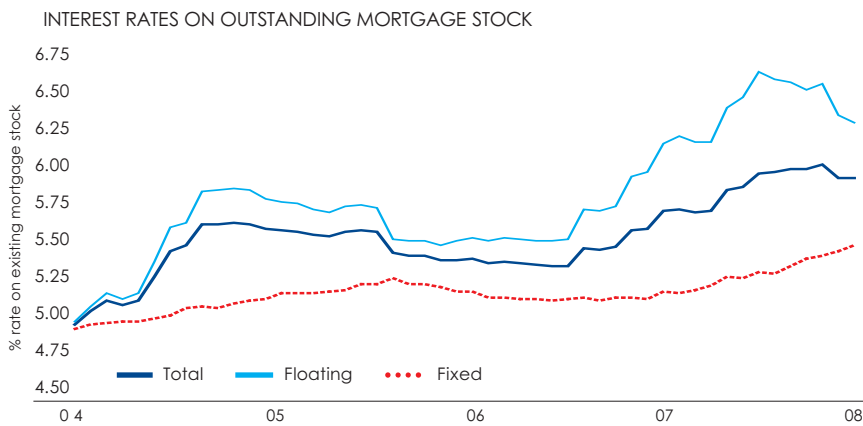


Figure 1

Source: Bank of England, LGIM estimates

The situation looks more precarious if we look at interest rates for new customers. For customers with deposits of at least 25% (say existing homeowners wishing to refinance or move house), new mortgage rates have fallen on average by 10bp from their peak – in line with the stock of existing mortgages. But for customers with only 5% deposits, mortgage rates are still rising (Figure 2). This suggests that banks are not interested in expanding their loan books to new customers but are able to refinance mortgages of high quality existing customers.

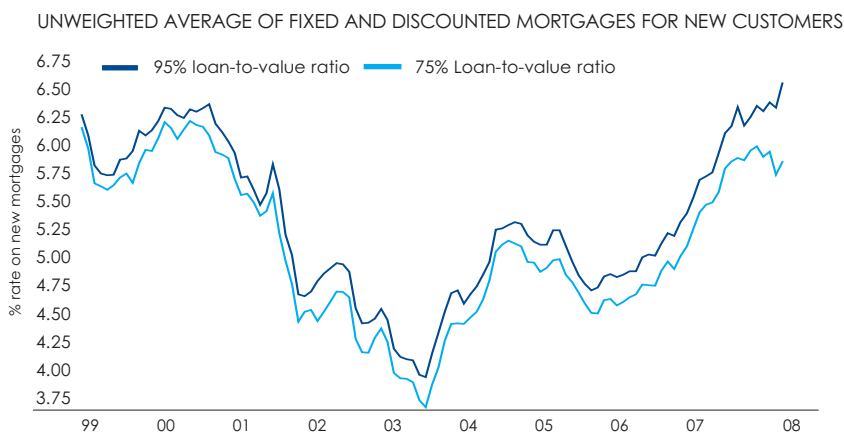


Figure 2

Source: Bank of England, LGIM estimates

The conclusion is that on an aggregate level at least, consumers are unlikely to experience any more pain from higher interest rate payments. Interest payments are likely to fall, but more gradually than we would normally expect for a given change in base rates. But housing transactions are likely to remain extremely depressed, putting downward pressure on house prices and consumer confidence.

Views Commentary

Consensus gloomier on growth

	Price Inflation (HICP)		GDP (Growth)		Earnings (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro		FTSE 100
	End 2008 %	End 2009 %	End 2008 %	End 2009 %	End 2008 %	End 2009 %	End 2008 %	End 2009 %	End 2008 %	End 2009 %	End 2008	End 2009	End 2008	End 2009	End 2008
ABN Amro	2.90	2.10	1.60	1.70	-10.00	0.00	4.85	4.85	5.00	5.00	2.03	1.98	0.78	0.74	5800
Citigroup Smith Barney	-	-	1.40	1.30	7.00	9.80	4.40	-	4.25	-	1.92	-	0.83	-	6200
CSFB	2.40	1.60	1.40	2.40	1.00	-	4.40	-	4.05	4.05	1.92	-	0.78	-	6000
Deutsche Bank	2.60	1.90	1.80	2.20	5.10	-	4.45	-	4.50	-	-	1.88	-	0.76	7200
Goldman Sachs	2.60	2.00	1.20	2.50	-0.50	12.40	4.50	4.70	4.50	4.50	1.97	1.85	0.72	0.72	6100
HSBC Securities	1.90	1.50	0.40	1.70	0.00	5.00	4.10	-	4.25	3.50	1.79	1.73	0.75	0.75	6200
JPMorgan	2.80	1.90	1.50	2.70	-	-	-	-	4.50	4.75	-	-	-	-	-
L&G Investment Management	2.60	2.30	1.50	1.50	4.00	4.00	4.75	4.60	4.50	4.00	2.00	2.00	0.77	0.81	6000
Merrill Lynch	2.70	2.10	1.80	1.80	4.00	6.00	4.45	-	4.50	4.50	1.87	1.68	0.79	0.76	6500
Morgan Stanley	-	-	1.70	1.80	-7.00	-3.00	5.10	5.30	5.00	5.25	1.84	1.76	0.76	0.75	6300
UBS	2.50	1.60	1.50	1.70	6.60	11.30	4.40	4.60	4.25	4.25	1.90	1.90	0.73	0.70	6500
Median (ex L&G Inv Mgt)	2.60	1.90	1.50	1.80	1.00	6.00	4.45	4.78	4.50	4.50	1.91	1.85	0.77	0.75	6300
Last Month	2.55	1.90	1.65	2.25	4.00	7.30	4.45	4.70	4.50	4.50	1.89	1.85	0.75	0.72	6750
Actual end :															
2007		2.10		2.90		6.20		4.51		5.50		1.98		0.75	6453
2006		3.80		3.00		12.20		4.74		5.00		1.96		0.67	6220
2005		2.00		2.00		22.70		4.10		4.25		1.72		0.69	5618

KEY Median figures indicate change over previous month 0.00 increase 0.00 decrease 0.00 no change

*This is our estimate of fair value at end 2008, not a point forecast.

Last month we cut our 2009 UK GDP forecast to 1.5%. This month, consensus followed suit, cutting their forecast from 2.25% to 1.8%. Our more bearish view stems from a prolonged global credit crunch. Consensus continues to expect UK inflation to fall below target in 2009. We still believe inflation will remain above target in 2009 as a weaker pound and strong commodity prices boost import costs. It is possible that a more pronounced economic slowdown than we currently expect could push inflation back below trend.

It's unclear how the Bank of England will react in an environment of weak growth and high inflation. Our model suggests the Bank of England could cut interest rates to 4% by spring 2009, below consensus expectations of 4.5%. The outlook for longer-dated bond yields is mixed. Lower short-term interest rates will reduce yields. But tax cuts will boost US government borrowing, potentially leading to a rise in global bond yields. Our model suggests gilt yields will end 2008 at around 4.75%, drifting slightly lower in 2009.

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