

Requiem for the USA

Following the worst decline in more than seventy years, the world's largest economy has returned to growth and appears to be gaining momentum. However, while the US economic recovery seems to be broadening – with employment growth likely to improve over the coming months – this cyclical improvement may not last long. Over the longer-term, a lack of domestic saving, excessive reliance on overseas borrowing and chronic fiscal deficits threaten to undermine the recovery. In this edition of Fundamentals, LGIM economist, Tim Drayson, explains why the US economic recovery is fragile and argues that US economic performance over the next decade is likely to disappoint investors.

Range bound

US Gross Domestic Product (GDP) grew by almost 6% (annualised) during the final quarter of 2009. While much of this growth was due to a one-off boost from inventories, there were also some signs of an improvement in underlying demand. Investment in equipment and software expanded briskly and consumer spending held up well despite

the end of the 'cash for clunkers' car incentive programme. The Federal Reserve (Fed) statement at the March Federal Open Market Committee meeting described activity as 'continuing to strengthen' and the Fed also acknowledged that the labour market was stabilising. In fact, a survey of economic forecasts ('consensus') shows that the average market

participant expects employment to increase, completing what is the final link for a self-sustaining economic recovery.

The cracks in the wall

While we remain more cautious than 'consensus' about the strength of the recovery, we also anticipate some improvement in the labour market over



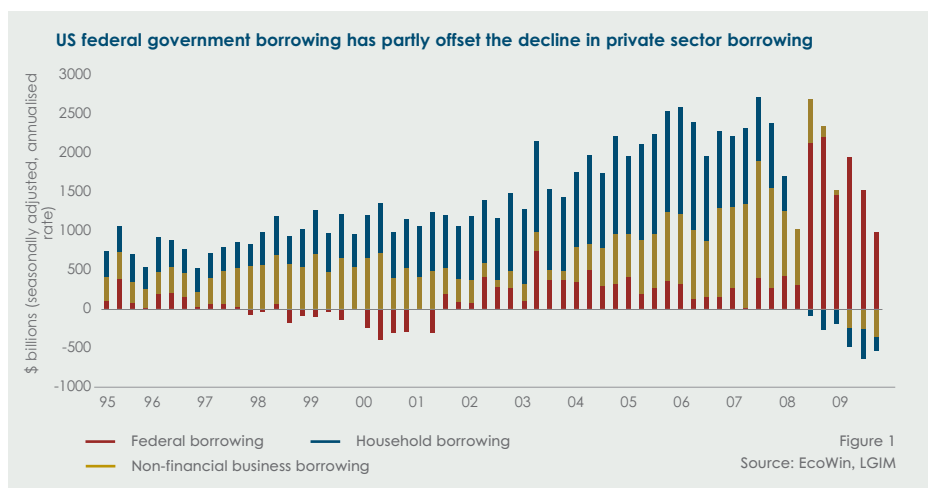
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the next few months and believe private demand will strengthen in 2011. Yet it is important to note that the catalyst for this growth has been storing up longer-term trouble. The US economy has been sustained over the last decade by a massive build up of debt. Recently, the private sector has begun to pay down some of this debt, but to prevent a more severe contraction in output, the government has significantly increased its borrowing (Figure 1). It has also effectively underwritten the mortgage market through its control of the Government Sponsored Enterprises. Essentially, the debt problem which emerged during the credit crisis hasn't gone away, the debt has just been transferred from the private sector to the public sector.

Part of the increase in government borrowing which has occurred during the past couple of years is automatic. For example, spending on unemployment benefits rises in a recession and tax receipts fall. But higher borrowing also reflects various stimulus measures which the government has introduced to lower taxes and increase spending. US government spending is now at a post Second World War high of 25% of GDP. In contrast, tax receipts have fallen to a low of 15%. So it will take years of rapid revenue growth and spending restraint to close this gap (Figure 2). The

overall budget deficit is even larger as it includes borrowing for investment spending. It's probably not desirable to cut federal investment to help close the budget gap as, at around 1% of GDP, it is already at a level insufficient to prevent a further deterioration in the creaking US infrastructure. State and local government investment, which is twice the size of federal investment, is already suffering cuts as they also struggle to balance their budgets.

The great debt transfer

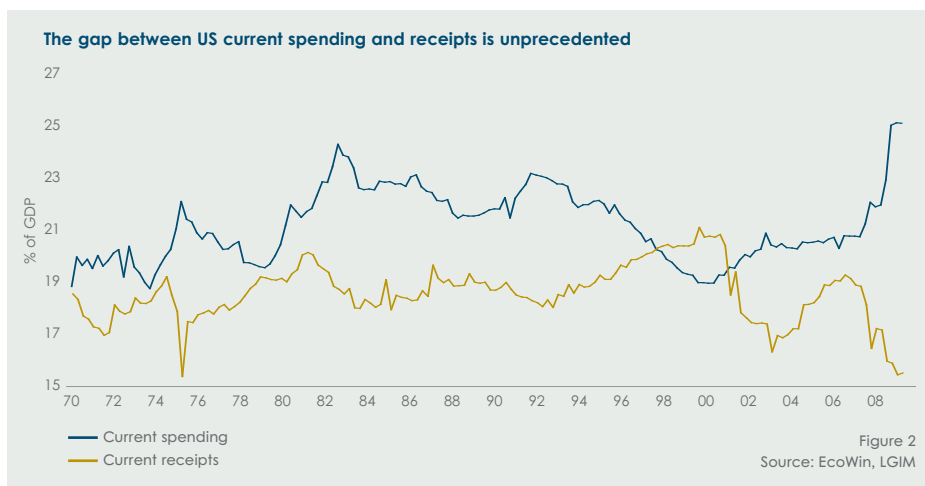
A closer examination of the federal deficit reveals that it is the household sector which has been the prime beneficiary. Household tax payments have fallen to less than 9% of income while transfer payments, which include social security payments and unemployment benefits, have soared to almost 18% of income. This

gap is unprecedented. In the late 90s, tax receipts more than covered transfer payments (Figure 3). This dramatic deterioration reflects not only the rise in unemployment but also generous increases in benefits and extensions to the number of weeks the unemployed are allowed to claim. In the absence of a large decrease in unemployment over the next few years, it is clear that higher taxes on households and cuts or freezes to transfer payments will be necessary to reduce the budget deficit. It seems unlikely that policy makers will want to implement these unpopular measures, unless some type of event, probably involving sharply higher bond yields and mortgage rates, forces them to.

Taxing the corporate sector is one option the government may take to reduce its deficit. However, tax receipts from companies have already recovered to some extent as profits have rebounded. They are currently around 2% of GDP, near the historical average. At most, the government could gain an additional 1% of GDP in tax revenue from the corporate sector, but any more would probably drive US companies increasingly overseas in search of more favourable tax jurisdictions.

The good news

While most recognise the fiscal challenges, the consensus seems to be that the private sector has now laid the



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foundation for a sustained economic expansion. The belief is that the financial crisis has forced the private sector to adjust and curb the excesses of the past. From a position of heavy borrowing, the private sector is now running a significant financial surplus. This is the difference between private sector saving and investment. Increases in private sector spending can now be funded by incomes and profits, rather than by more borrowing (Figure 4).

During the past decade the household sector as a whole has spent more money than it has earned in income (i.e. it has been a net borrower). In order to cover the gap, household liabilities increased. The debt acquired was also used during this period to acquire assets. Since 2008, however, the household sector has become a net lender. The savings rate has risen and more importantly households have cut back sharply on physical investment in properties. Households have also significantly reduced mortgage borrowing. However this doesn't affect the household net lending figures which only count deposits on houses, mortgage repayments and home improvements as household investment. With household net lending back to early 1990s level, the household sector adjustment appears over and that suggests consumer spending could grow in line with income growth again.

The corporate sector ran a large financial deficit in the late 1990s to fund the technology investment boom. After a period of balance sheet repair following the 2001 recession, companies became net borrowers again, even as the US housing market began to falter. This sustained the expansion until lending conditions became tight in 2008. The crisis led to significant cuts in investment, dividends and employment. Currently, post-tax profits minus dividends more than cover the low level of investment, leading to a financial surplus. Therefore, even if credit conditions remain tight for a while yet, most companies are no longer reliant on bank lending or the capital markets to fund increasing spending as they have a large financial surplus.

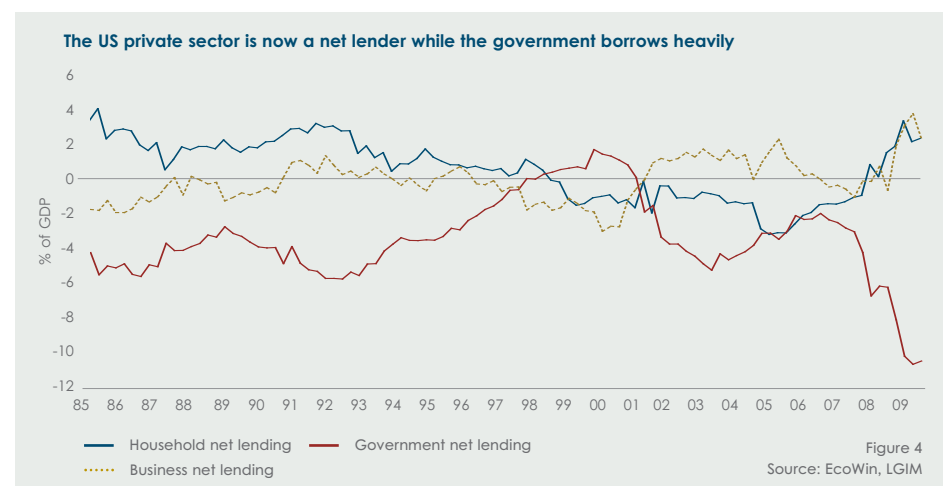
The bad news

The major flaw in this line of argument, however, is that it ignores the source of

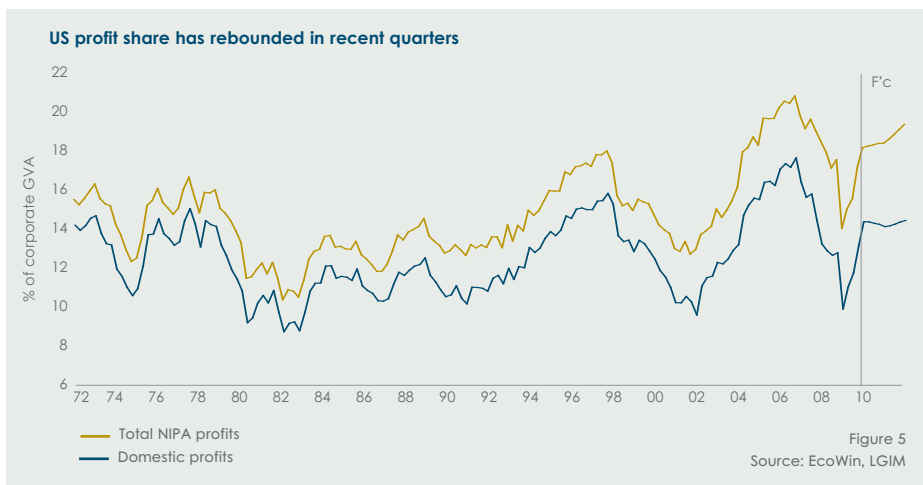
this cash. As discussed earlier, this has come from the massive transfer of funds from the government to the private sector. The increase in benefits and lower tax payments has protected household disposable income and cushioned consumer spending while at the same time allowing the corporate sector to cut costs without experiencing the negative feedback of even lower sales as a result of paying workers less. This is why corporate margins (or the profit share of output) have rebounded quickly following the sharp fall at the end of 2008 (Figure 5). Households have spent the government's borrowed money, allowing corporate sales and profits to improve. But it is clearly unsustainable for the consumption share of GDP to remain at a record high while labour compensation share of GDP is at a 50 year low.

This is only possible because the government is currently running a GDP deficit of 11%. It is inevitable that the private sector would run a surplus in this environment, because the sum of the sector financial balances is equal to the current-account balance. The current-account deficit is still around 3% of GDP, having fallen from a peak of 6%.

If private sector spending increases, this should lead to some improvement in the budget deficit, but also a



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renewed widening in the current-account deficit. This has to be financed by capital inflows from abroad. Decent US growth might support the US dollar for a while, but it is debatable whether the rest of the world will be willing to increase its rate of US asset purchases. This is particularly the case as the US is effectively relying on overseas funding for its welfare spending, rather than productive investment. The twin budget and current-account deficits should eventually put pressure on the dollar.

The final worrying aspect is the chronic lack of saving in the US economy. The sharp fall in investment over the last couple of years should have led to a much larger improvement in the current-account deficit, but saving has fallen almost as fast (Figure 6). The current-account deficit can also be thought of as the counterpart of whole economy saving and investment as well as the sum of the financial positions of the different sectors of the economy. So without a rise in saving, any increase in investment from today's low base is likely to lead to a further widening of the current-account deficit. When depreciation is considered, net saving has turned negative. This means the US is relying on overseas funding just to maintain the real value of the capital stock. In the absence of a decent rebound in investment, US productivity growth is likely to suffer. A large part of productivity growth is

embodied in the investment process, through either the production or use of new capital equipment. Using the existing capital stock more efficiently is a more modest contributor to productivity growth. We have seen strong increases in productivity during the last couple of quarters, but this is cyclical and is related to expansion of the budget deficit which as described above allowed firms to cut costs without hurting sales. Now the budget deficit has reached its limit, any further corporate cost cutting will undermine consumer spending, reducing scope for productivity gains.

A period of adjustment

The expansion of the budget deficit was probably necessary to avoid an even worse outcome last year. Now that growth has returned, policy-

makers need to begin bringing the deficit under control. A return to near balance within the next five to ten years is essential given the longer-term pressures from deteriorating demographics and rising healthcare costs. Whether through reduced transfer payments, spending cuts or tax rises, all routes will ultimately reduce household income. Private sector wages and salaries will once again become the most important source of income for spending, which inevitably means it will become much harder for the corporate sector to expand margins.

This will allow the economy to gradually rebalance and the level of savings across the whole economy to drift higher. It might keep unemployment relatively high for a few years, but it would ultimately set the stage for a more durable expansion. The alternative is to ignore the budget deficit and let the economy grow faster. This seems to be the current policy. This might work for a time, but if it leads to a widening of the current-account deficit, the rest of the world might begin to lose confidence in US fiscal sustainability, risking crises in the US bond and dollar markets.



Market Overview

A batch of broadly reassuring newsflow at both the economic and corporate level supported the view that the steady but unspectacular global economic recovery remains on track. Equities inched steadily higher during the month while bond investors drew some reassurance that the Greek debt crisis will be managed through a face-saving combination of European and International Monetary Fund loans.

Better-than-expected US employment numbers and robust eurozone industrial production data set global equities' generally positive tone for the month. The breakneck speed of China's economic rebound continues to drive Asian economic activity, while strong Japanese retail sales figures demonstrated the success of the government's economic stimulus package. As expected, the UK Budget proved to be little more than political window dressing ahead of the imminent general election, though a slide in inflation raised hopes that interest rates can stay on hold throughout 2010. However, investors kept close tabs on the political wrangling surrounding the ongoing Greek debt saga; though a short-term political solution was agreed providing an IMF-backed safety net, other countries looked on nervously at the lack of a definitive longer-term solution which would prevent the crisis spreading elsewhere in the eurozone and beyond later this year.

Equity Overview

UK

Election ahead

The latest batch of UK economic news painted a rather brighter picture than February's gloomy releases. Gross Domestic Product numbers for the final quarter of 2009 were upwardly revised again, showing that the economy grew by 0.4% rather than the original 0.1% estimate. The latest unemployment figures fell, partly reflecting workers' willingness to accept flexible arrangements to hold onto their jobs. Following January's snow-related retail sales slowdown, High Street tills were ringing in earnest again in February, though the longer-term trend remains fairly soft. Meanwhile, inflation fell sharply from its earlier spike as base effects – such as the VAT rate reversal – fell out of the annual calculation, with consumer price inflation dipping from 3.5% to 3.0%, a sharper fall than most commentators had foreseen.

As expected, the pre-election Budget offered little by way of how the government plans to address the massive deficit. Nevertheless there was at least some relatively good news as the Chancellor revealed that net borrowing will amount to £167bn for the present financial year, compared to the £178bn previously forecast. With the main parties seemingly now resigned to

EQUITY OVERVIEW

as at 31 March 2010

Market return (denominated in £)	March (monthly) return %	Rolling 12 month % return
UK	6.3	5.4
US	6.4	11.9
Europe	7.1	3.6
Japan	4.7	14.5
Asia	7.6	7.8

Major Equity Markets – Total Returns £ 2009/2010



cut spending and the debate centring on when to begin cutting, lower government spending looks set to drag on UK economic activity next year, if not before.

Against this backdrop, UK equities made steady gains during the month. With global demand for metals on the up as emerging economies forge ahead, mining stocks outperformed the wider market. Industrials and financials also performed well on optimism over the improving economic outlook, though traditionally defensive sectors such as utilities and healthcare underperformed.

US

Recovery well on track

The latest batch of economic releases suggest the US economic recovery is continuing, albeit with some indicators marginally weaker than forecast. The market took comfort from a mid-month pledge from the Federal Reserve that interest rates are set to remain at 'exceptionally low levels' for 'an extended period'. This pledge was further underlined by more good news

on the inflation front, as consumer prices held steady between January and February. Meanwhile a fall in US producer prices lent weight to the view that the economy is facing few inflationary pressures. Consumer spending rose in line with forecasts during February, representing the fifth consecutive rise in spending. Against this broadly-favourable economic backdrop, news that economic growth for the final quarter of 2009 was revised marginally lower from 5.9% to 5.6% on an annualised basis was taken in the market's stride. Investors noted that the growth in 'real GDP', a measure of inflation-adjusted growth, was attributable to higher business investment in equipment and software as well as a slowdown in the rate at which businesses are drawing down on their inventories.

The broadly supportive economic backdrop helped US equities achieve solid gains over the month. With sterling largely holding steady against the dollar, the FTSE All-World North America index rose by 6.4% for sterling-based investors.

Equity Overview Contd.

▶ EUROPE

Greek deal eases eurozone stresses – for now

Following the political wrangling over recent months over how best to address the Greek debt crisis, European leaders eventually shook hands on a compromise deal involving a substantial contribution from the International Monetary Fund. Though the deal should avert the risk of a Greek sovereign default and temper the market's near-term enthusiasm to drag other debt-heavy countries towards the abyss, the true test is still to come as Greece could yet face a struggle to roll over its hefty debts over the next few months.

Evidence continued to emerge to highlight the growing economic divide between core and peripheral eurozone countries. Greece's own central bank warned that the country's economy is in a vicious circle with the economy set to shrink this year as budget cuts begin to bite. Meanwhile Portugal was hit by a credit ratings downgrade from Fitch, despite passing an austerity budget to help address its deficit woes. On the other hand, Germany's Ifo Business Climate survey continued to paint a rosy picture among manufacturers, wholesalers and construction companies, with the key index hitting its highest level.

European equities, as represented by the FTSE AW – Developed Europe (ex UK) Price Index, rose by 7.1% in sterling terms over the month as the UK currency held relatively steady against the euro.

▶ JAPAN

A fragile recovery

The Japanese economy has continued to grow over recent months, though the softer tone of March's official data releases suggested that the recovery remains reliant on government support measures. The latest numbers showed that February's retail sales leapt by 4.2% compared to a year earlier, boosted by government incentives designed to persuade traditionally-cautious Japanese consumers to part with their cash. However, having grown strongly in January, the latest industrial product figure dipped for the first time in a year, raising concerns that manufacturers are not feeling a totally-consistent uplift in demand.

Though the latest unemployment number held steady at 4.9%, unease persists over the extent to which the recovery in domestic demand is reliant on government spending initiatives, particularly as tight state finances limit the scope to maintain stimulus measures over the medium term. Japan's central bank recently doubled the funds made available to banks as cheap short-term loans in an effort to combat lingering deflationary pressures. Meanwhile revised data showed that the economy grew by 0.9% during the final quarter of 2009, compared to the previous 1.1% estimate.

Japanese equities, as shown by the FTSE AW – Japan total return index, rose by 4.7% during March in sterling terms.

▶ ASIA / EMERGING MARKETS

In the driving seat of the global economic recovery

Yet more evidence emerged that developing economies are forcing the pace of the global economic recovery, though unease remains that the rampant Chinese economy could be overheating. The latest inflation data did nothing to allay these concerns, with February's consumer price inflation jumping to 2.7% from January's 1.5% (year-on-year basis). Meanwhile producer prices soared by 5.4% in February compared to a year earlier. With much of the developed world struggling to shake off the shackles of the recent recession, the confidence and clout of Chinese companies was amply demonstrated by news that Zhejiang Geely Holding Group, the country's biggest privately-run car manufacturer, has agreed to buy Ford's Volvo car unit for \$1.8 bn. China continued to resist pressure from the US administration to let its currency float, thereby removing some of Chinese exporters' competitive advantages over their Western peers.

Following a string of interest rate increases, Australia's central bank hinted that further tightening could be on the agenda to return interest rates to 'normal' levels. Earlier in March Australia increased interest rates for the fourth time in five months, as the country's economy continues to benefit from a rising population and booming regional demand for resources, notably from China.

Fixed Income

Government bond yields rose moderately in Germany, France and Japan during March, though UK 10-year yields ended the month largely unchanged as converging opinion polls raised the prospect of a hung parliament, potentially scuppering the Conservatives' proposals for near-term cuts to address the deficit. US Treasury yields climbed higher as investors concluded that the economic recovery will feed through to lift interest rates later this year, despite the Fed's pledge to keep rates low for an 'extended period'.

However, with the eurozone's political elite finally reaching agreement to help provide an IMF-assisted last-resort bailout package for Greece, yields on Greek, Portuguese and Spanish government debt narrowed as investors factored in a slightly-reduced risk premium.

Major Bond Markets – Total Returns £ 2009/2010



Figure 2
Source: Datastream

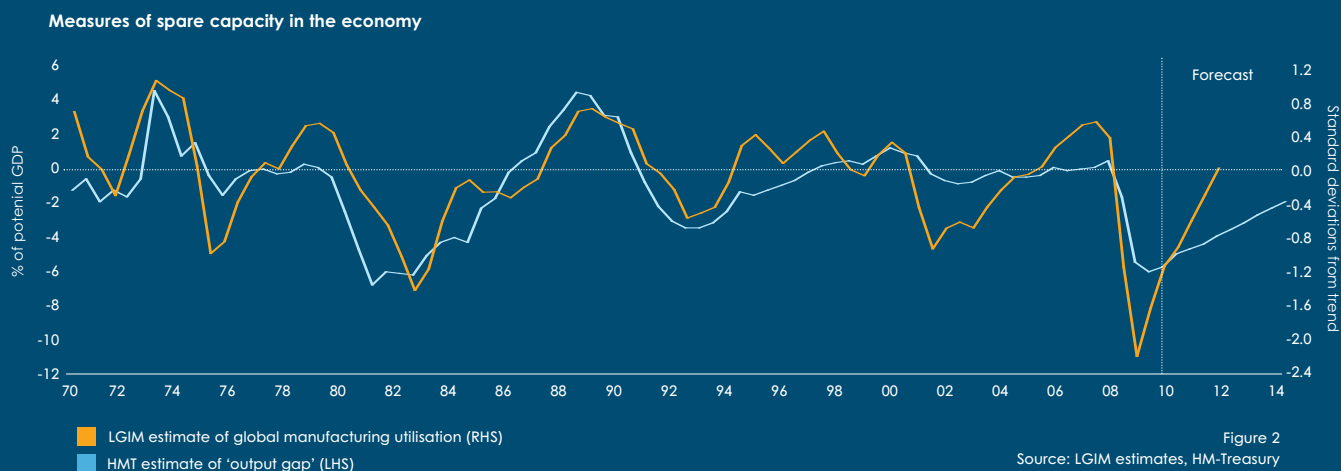
Snapshot

Attention deficit

The Chancellor of the Exchequer Alistair Darling recently published his latest budget. He expects government borrowing to fall from a peak of just under 12% of GDP in 2009 to 4% by 2014. This is due to a combination of a planned slowdown in government spending as well as the belief that a stronger economy will boost tax receipts. The government wants to curtail borrowing to prevent a financial crisis similar to what we've seen in Greece so far this year. Greek government bond yields jumped to 7.5% in early April 2010 from a low of 4.4% in October 2009. This threatened to cause a debt-spiral whereby the government had to borrow more money just to finance the debt servicing costs. So the Greek government has been forced to raise taxes and make sharp cuts in public spending.



Are the UK Chancellor's forecasts too optimistic? This mainly depends on whether he delivers on the planned slowdown in public spending or not. At this stage, the government has pledged to grow overall cash spending by just 1% in 2011, but he has not yet identified how much each department will get. We broadly agree that tax receipts will improve from here. Our tax receipt forecast for 2011 is similar to the Chancellor's for example (Figure 1). This is despite the fact that we have a weaker real GDP growth forecast than the Chancellor for 2011 (2% vs 3%). We believe that will be offset by the recent improvement in financial and housing markets.



Looking beyond that, it depends how fast and for how long the economy can grow without generating inflation. The government believes the economy is currently operating well below potential. This means it can grow at a rapid pace for many years without generating inflation. The faster the economy grows, the more government spending can grow while still seeing an improvement in the public finances. This is because public spending as a share of GDP will fall so long as spending grows slower than the economy. The government plans to grow cash spending by 2.5% in 2012 and 2013. We're unsure the economy can grow rapidly for as long as the government expects. Our forecasts suggest the global economy will get back to its sustainable long-term trend during 2012 (Figure 2). Beyond this, above-trend growth should boost inflation, forcing interest rates higher to slow the economy. This suggests borrowing in the medium-term might remain higher than the government projects.

UK Forecast

More optimistic than consensus for 2010

UK Economy		Price Inflation (HICP)		GDP (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro	
		2010	2011	2010	2011	End 2010	End 2011	End 2010	End 2011	End 2010	End 2011	End 2009	End 2010
Market participants forecasts		%	%	%	%	%	%	%	%				
	High	3.00	2.60	2.20	3.10	5.10	5.10	2.00	2.50	1.77	1.81	0.97	1.04
	Low	2.10	1.20	0.60	1.20	3.40	3.50	0.50	0.50	1.31	1.39	0.80	0.78
	Median	2.60	1.90	1.20	2.25	4.60	4.75	0.75	3.00*	1.54	1.60	0.87	0.85
	Last month median	2.50	1.70	1.20	2.05	4.50	4.75	0.75	1.25	1.62	1.62	0.87	0.86
Legal & General Investment Management		2.40	1.30	1.60	2.00	4.50	5.00	0.50	1.00	n/a	n/a	n/a	n/a

*Based on a small sample size at time of going to print

Source: Bloomberg and LGIM estimates

The forecasts above are taken from Bloomberg and represent the views of between 20-40 different market participants (depending on the economic variable). The 'high' and 'low' figures shown above represent the highest/lowest single forecast from the sample. The median number takes the middle estimate from the entire sample.

We remain more optimistic than the median market participant ("consensus") regarding the pace of UK economic growth in 2010. While official GDP data has not been as strong as we anticipated six months ago, most recent data show that the UK economy grew much faster than first thought (at 0.4%) during the final quarter of 2009.

Although we anticipate a slower start to 2010 - with first quarter growth restrained by snowy weather in January - we believe UK GDP will reach 1.6% for the year (versus a forecast of 1.2% from consensus). Our optimism stems from a belief that exports will be stronger than consensus is currently factoring in. Our export model points to double digit year-on-year growth during 2010. The time-lag between the weakness in the pound and export performance remains unclear as many businesses have contracts which are fixed in price denominated in a foreign currency. However, we expect a sharp rebound in export markets (recovering from low levels in 2009) to lead this positive contribution to total growth from exports.

We expect UK inflation to fall quicker than consensus as we head into 2011. Our model suggests inflation, at 1.3% in 2011 will be significantly below the consensus reading of 1.9%. As a result, our Bank of England model is not suggesting any rate hikes in 2010. While we cannot rule out some tightening in 2011, we maintain our view of no official rate rises in 2010.

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Legal & General Investment Management Ltd, One Coleman Street, London, EC2R 5AA
www.lgim.com

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