

Will it last?

The global economy emerged from intensive care during 2009. A year ago financial markets were left reeling after enduring a systemic failure of the banking system and one of the sharpest, deepest recessions on record. Throughout the course of the year policy makers undertook extraordinary measures to rebuild confidence in the financial system and stimulate economic activity. As we head into 2010, economic data has begun to improve and financial markets have responded with enthusiasm. In this edition of Fundamentals, LGIM's economists and strategists discuss whether the recovery is sustainable and provide their forecasts for major investment markets in 2010.

Life support

As the financial crisis intensified last year, prompt action by policy makers across the globe successfully prevented the global recession turning into something far worse.

As 2009 draws to a close, growth has now returned to most parts of the world. Emerging markets have led the way, rebounding strongly. Among the major developed countries, only the UK failed to provide a positive reading on economic growth (GDP) for the third quarter.

The return to economic growth has been accomplished by a combination of an unprecedented policy response and a pronounced global inventory cycle.

As global credit markets seized up last year and trade finance became prohibitively expensive, firms drastically cut back on production and met sales demand from their existing stock of inventory. While demand clearly suffered at the height of the crisis, a combination of lower interest

rates, fiscal support and reduced energy costs helped to stabilise consumer spending through 2009. This has led to a rapid reduction in inventory levels. This inventory cycle is remarkably synchronised across the world. By the middle of the year companies could see that production levels were insufficient to meet demand. Unless production increased, inventories were set to become too lean. Subsequently, global trade and production has enjoyed a sharp rebound in activity.



Inside:

Market Overview

Snapshot: US inventory cycle to boost growth

Forecasts: Revisions ahead

Article Contd.

	2007	2008	LGIM			Consensus		LGIM Medium term
			2009	2010	2011	2009	2010	
Summary table for key macro variables and asset class returns								
GDP, % yoy								
UK	3.0	0.7	-4.2	2.0	2.3	-4.5	1.3	2.25
US	2.2	0.4	-2.5	2.3	2.3	-2.5	2.7	2.25
EU	2.6	0.7	-3.9	2.1	2.1	-3.8	1.2	1.75
Japan	1.9	-0.7	-5.3	1.9	1.5	-5.4	1.5	1.00
Developing	7.9	6.1	2.1	6.5	5.3	1.0	4.7	4.50
World	3.7	2.3	-1.8	3.6	3.3	-2.0	2.8	2.75
CPI, % yoy								
UK	2.3	3.6	2.2	2.4	1.3	2.1	2.1	2.00
US	2.9	3.8	-0.4	1.6	1.3	-0.4	2.0	2.25
EU	2.1	3.3	0.4	1.0	1.4	0.3	1.4	1.90
End year level								
US Fed funds	4.25	0.10	0.10	0.10	0.50	0.25	1.00	4.50
UK base rate	5.50	2.00	0.50	0.50	1.50	0.50	1.25	4.50
ECB base rate	4.00	2.75	1.00	1.00	1.00	1.00	1.50	3.50
10-year Treasury yield	4.10	2.20	3.50	4.00	4.50	3.46	4.23	5.00
10-year gilt yield	4.60	3.10	4.00	4.50	5.00	3.67	4.43	5.00
FTSE 100	6456	4500	5300	5600				8% total return

Figure 1
Source: LGIM, Datastream

A strong finish

Our calculations suggest that at the start of the fourth quarter of 2009, the world was around half-way through the process of bringing production back towards the level of final sales. This should lead to some decent GDP readings for the final quarter of the year. But by early next year, destocking should be largely complete. There is a risk that companies decide to embark on a period of over-production to restock. But we feel firms will be comfortable holding a lower level of inventories than before the crisis given the fall in demand, caution about the outlook and unwillingness or ability to access credit.

As destocking ends, this should be reflected in either a stalling or perhaps even some softening in many business surveys. This could trigger fears of a 'double-dip', even if such an outcome is avoided.

The outlook for 2010

The developed world

Once the boost to growth from firms rebuilding inventory levels and various fiscal stimulus measures wears off, we expect underlying demand to be sluggish and the developed economies to only gradually strengthen through 2010. Exports typically lead a recovery following a recession but this channel doesn't work when your trade partners are also struggling. UK and US exports

should perform relatively well given their currency weakness. Emerging market demand should provide some support, but at the moment it is not large enough to offset the lack of demand from developed countries.

The other route to recovery is lower interest rates. Cheaper debt typically encourages those still in work to borrow more. But credit conditions remain tight and households are in the process of repairing their balance sheets. Debt is likely to be paid down and saving rates will rise, especially in those countries which have suffered the steepest falls in house prices. This makes consumption growth heavily reliant on wages and salaries. While we expect job shedding to ease, we think companies will be slow to hire. With unemployment high, wage growth is likely to be subdued. The corporate profit

outlook has improved and companies are beginning to generate sufficient cash flow to fund an expansion in business investment. Unfortunately, with so much spare capacity and an uncertain outlook for final demand, companies are unlikely to commit to new investment spending beyond the level necessary to cover depreciation.

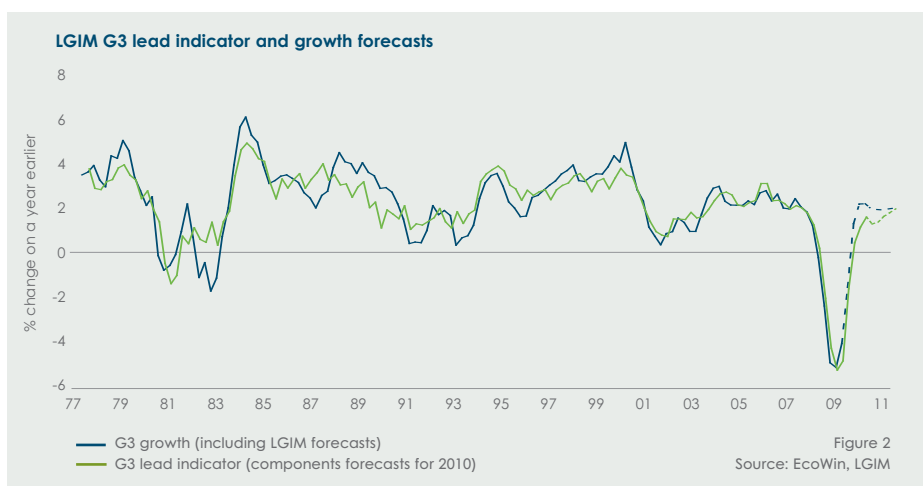
In an environment of high unemployment, excess capacity (where firms are producing less than optimal levels of output) and only a modest recovery in demand, we expect inflation pressures to remain muted over the next year. Headline inflation is likely to increase sharply over the next few months as energy prices have risen, but we see little impact on core inflation (a measure which excludes volatile items such as food and energy). Higher commodity prices probably pose more of a risk to growth as they squeeze real incomes.

Given the subdued growth and inflation outlook, it is too early to withdraw from ultra-easy monetary policy.

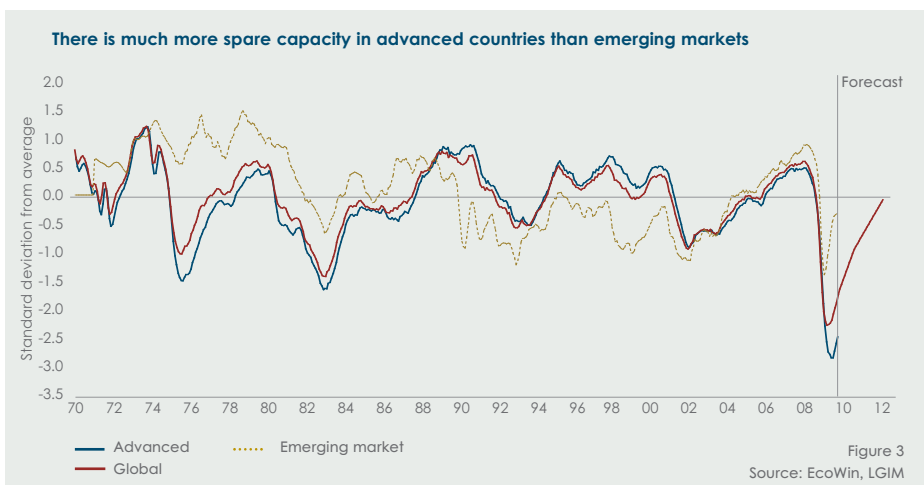
We don't anticipate either the US Federal Reserve, Bank of England, ECB or Bank of Japan raising rates next year.

The emerging world

With the exception of Central and Eastern Europe, emerging markets have come through the crisis relatively unscathed. Governments in many of these countries



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were generally in strong fiscal positions ahead of the turmoil and aggressive stimulus plans have supported demand, most notably in China. Domestic monetary policy has also proved effective. As commodity prices collapsed last year, inflation pressures faded and interest rates were cut to record low levels. In contrast to the developed world, the household credit culture is in its infancy. Consumers can now access credit at attractive rates for the first time and this is boosting spending on consumer durables. For example, car sales have hit record highs in many countries. The danger is policy will be kept too low for too long encouraging a domestic credit boom.

What does it all mean for investors?

Government Bonds

The Fed (US Federal Reserve) has now completed its \$300bn purchase of US Treasuries (as part of its programme of quantitative easing), but it is still buying large quantities of mortgage-backed securities. This is likely to continue through to the end of March 2010. By forcing down mortgage rates this has encouraged the private sector to switch into Treasuries. As this support from the US central bank fades, bonds look vulnerable, particularly in an environment of large structural government deficits and potentially diminished overseas central bank buying. While the near-term inflation

outlook is benign, US inflation-linked bonds offer protection against US policy-makers' longer-term bias towards inflation rather than deflation.

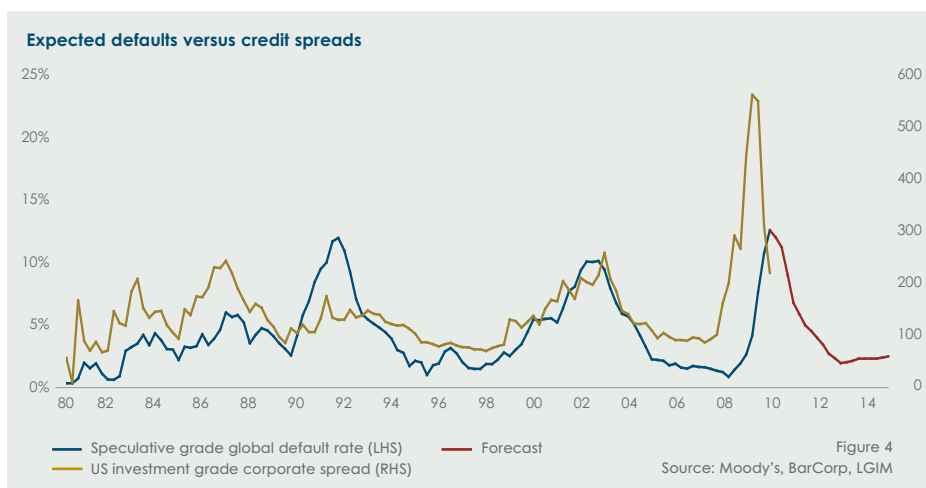
In the UK, the outlook for 10-year gilts is also highly uncertain, but will clearly be influenced by developments in the US bond market. By February 2010, the Bank of England (BOE) will have completed £200bn of quantitative easing. This is almost entirely taken up by gilt purchases, and has almost certainly artificially depressed yields. It seems unlikely that the market will be able to absorb the huge amount of new issuance likely to occur over the next few years without higher yields. We don't expect the BOE to sell any of its gilt holdings over the next couple of years as this would probably prove disruptive to the market. Much hinges on the fiscal plans presented by the next

government. They will need to be credible to prevent a more abrupt move higher in gilt yields.

Corporate bonds

Corporate bonds have performed very well in 2009. While they no longer offer investors historically high levels of income, it is important to realise that income levels at the start of 2009 were to compensate investors for the extraordinary risks they faced at the time. Over the course of the year, a financial meltdown has been avoided and a 1930's style depression has not materialised. Given this improvement, the pick-up offered by credit over very low gilt yields is still an attractive proposition for investors heading into 2010.

However, for credit to perform well in the coming year, we need to maintain an economic goldilocks scenario of not too fast and not too slow. If interest rates rise rapidly under a strong economic rebound, all bond assets will come under pressure. On the other hand, a double dip recession could undermine investors' fragile risk appetite, leading to credit underperforming cash and government bonds. Broadly, the outcome we believe most likely in 2010 treads a middle ground, allowing us to be constructive on the outlook for credit. But we do not expect an easy ride and investors need to be ready to take advantage if conditions change throughout the year.



Article contd.

Commercial Property

During the first half of 2009 commercial property markets were characterised by a dearth of investment demand, disposals by a number of leveraged investors and funds satisfying redemptions. Pressure on capital values drove income yields to historic highs. The second half saw a major turnaround; greater inflows to retail funds and increased allocations from institutional investors, combined with continuing demand from overseas purchasers. This led to a stronger balance of buyers and sellers and a swift bounce back in performance.

However, the prospects for property incomes at a macro level remain challenging. Demand for space has been hit by the recession, pushing vacancy rates above average and leading to lower rents. The modest pace of economic recovery described earlier will mean that excess space takes time to be absorbed, resulting in further pressure on rents over the year ahead.

We therefore expect a major divergence in performance between high quality assets with secure tenants in place and those with very short leases or voids which are more exposed to the weak occupier markets. The more competitive investment market also presents a challenge for managers tasked with investing new allocations. With a greater number of buyers chasing limited stock on the market, managers who can source stock creatively off market, either by virtue of scale or network of contacts, should achieve relatively favourable performance.

Equities

We believe interest policy rates will remain on hold throughout 2010 which will provide strong support for equities. However for markets to make meaningful progress, investors will need to see evidence of sustainable economic growth in order to absorb comments by policy makers

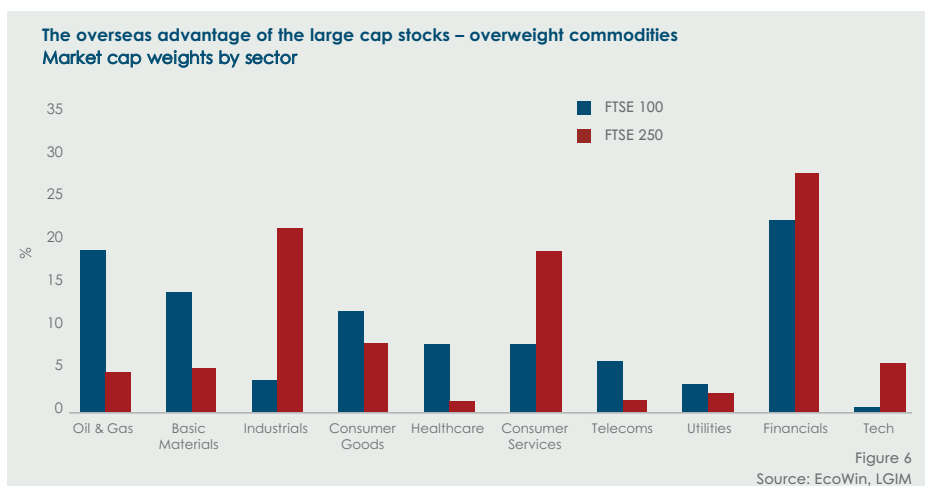


surrounding exit strategies and a gradual removal of liquidity from the financial system.

Against this backdrop we believe there are two key opportunities for equity investors. Firstly, in a world where we believe interest rates will remain low for an extended period of time, areas of the equity market offering a yield premium are a great investment opportunity. Twelve months ago the dividend yield on the UK market reached over 5%. This looked fantastic. However, at the time we believed this level of dividend yield was not sustainable. After falling 20% over the course of this year, the dividend yield in the UK is now around its long-term average of 3.5%. We now believe this yield is sustainable into next year, with a number of companies either growing or reintroducing their dividends over the next few months.

Another theme which clearly emerges from our economic outlook is a focus on the Emerging Markets for revenue generation. However this does not mean that only equity markets in the Emerging Market region will hold up fairly well. Investors should ensure they have revenue exposure to the higher growth potential from developing economies. This can be achieved through their developed market exposure via individual stocks or sectors.

These two themes support a positive stance on larger, blue chip stocks. The FTSE 100 offers a higher dividend yield over the smaller companies index. In addition larger companies have a higher proportion of their revenue generated overseas (Figure 6), which will take advantage of our higher than consensus view on Emerging Market economic growth.



Market Overview

Following a pause for breath in late October, financial markets resumed their uptrend in November. With massive government economic stimulus packages continuing to underpin confidence, there were fresh signs that Western consumer activity is generally improving, despite stubbornly high levels of unemployment.

US equities were at the forefront of global markets' gains during the month, with Japan the only major market to experience a setback. In sector terms, the materials sector was buoyed by rising metals prices, while other cyclical sectors such as industrials broadly outperformed. However, following exceptionally strong returns since their first-quarter lows, financials generally underperformed as investors digested news that Dubai World is seeking to restructure its obligations.

Equity Overview

UK

Rocky road to recovery

The UK economy continues to lag other major developed economies, officially remaining in recession. However, confidence returning to the housing market and fresh signs of improvement in the manufacturing sector should help restore economic growth during the final quarter of 2010.

UK equities climbed by 2.5% during the month of November, as measured by the FTSE All Share price index, lifting the market's return over the first 11 months of 2009 to 19.9%.

Soaring metals prices supported the materials sector, with BHP Billiton among the leading performers. Food producers & processors delivered good returns in November, with Cadbury rising on speculation that Hershey and Ferraro could outbid Kraft Foods for the confectionary maker.

The household goods sector also outperformed as encouraging comments from housebuilders Persimmon and Barratt chimed with survey evidence of rising prices. However, the banking sector suffered a poor end to the month as existing concerns over bad loans were overshadowed by fears over potential exposure to Dubai after the investment unit Dubai World effectively defaulted by requesting a six-month delay in its loan repayments.

EQUITY OVERVIEW

Total return (denominated in £)	November (monthly return %)	Calendar year-to-date (11 months %)
UK	2.5	19.9
US	6.2	8.3
Europe	3.3	12.6
Japan	-0.6	-9.4
Asia	2.6	40.2

Source: Datastream, FTSE indices shown

Major Equity Markets – Total Returns £ 2008/2009



Figure 1
Source: Datastream, FTSE indices shown

US

Building on material gains

Since the October publication of data confirming that the US had emerged from recession, evidence has continued to suggest that the economic backdrop is steadily improving. Though the unemployment rate ticked above 10%, the manufacturing sector continued to grow while both consumer confidence and spending have staged further gains. News from the housing market was also broadly encouraging, with both transaction volumes and prices, as measured by the Case-Shiller index, rising. However, with the figures distorted by the effects of a homebuyers' tax credit incentive, the US housing market is by no means out of the woods yet. Nevertheless, US exporters are likely to benefit from the dollar's extended losing streak as the greenback sank to 14-year lows against the yen. The latest weakness was exacerbated by apparent official approval of the slide after the minutes of a Federal Reserve meeting described the currency's move as 'orderly'.

US equities rose 6.2% in November (as measured by the FTSE All-World North America price index in sterling). Since the turn of the calendar year US equities gained 8.3% in sterling terms.

EUROPE

Recovery gains new traction

Fresh evidence emerged during the month that Europe's economic recovery is gaining traction. Concerns persist, however, as to whether final demand from consumers is sufficient for the recovery to be self-sustaining as government-backed stimulus measures are withdrawn.

Economic activity across the 16-nation eurozone grew at its quickest pace in two years (according to survey data) helped by a strong performance by the manufacturing sector. However, signs of a drop in new orders underlined lingering fears that the eurozone's recovery remains fragile, with high reliance on stimulus measures, vindicating recent comments from senior European Central Bank officials.

Though rising export volumes have supported manufacturers, fresh political disquiet over dollar weakness versus the euro emerged in the form of comments from a key advisor to France's President Sarkozy.

European equities, as measured by the FTSE AW – Developed Europe (ex UK) Price Index in sterling, rose 3.3% in November. Over the first 11 months of the year the index has gained 12.6%.

Equity Overview Contd.

JAPAN

Haunted by deflation

Japanese equities lagged the other major developed markets in November. Concerns that deflationary pressures are returning are jeopardising the country's nascent economic recovery. November's headline consumer price inflation figure fell by 2.5%, echoing the country's economic malaise as inflation turned negative during the infamous 'Lost Decade'. Against this backdrop, the Bank of Japan has continued implementing its programme of quantitative easing and introduced a new lending facility intended to stimulate economic activity.

Concerns over the impact of the yen's strength against the struggling dollar also dogged sentiment to leading Japanese manufacturers given the impact on revenues earned in the vital US market. Though we remain positive on the outlook for Japanese exports in volume terms, we retain a cautious view on the domestic economy while stretched government finances look set to limit the room to

manoeuvre over further fiscal moves to support the Japanese economy.

Following their 0.6% decline over the month, by the end of November Japanese equities were 9.4% below their levels at the turn of the calendar year, as measured by the FTSE AW – Japan total return index in sterling terms.

ASIA / EMERGING MARKETS

In the driving seat of world growth

Asian & emerging markets moved broadly higher amid fresh signs that the regions are playing a key role in helping the global economic recovery to gain vigour.

Latin American markets enjoyed robust gains, driven by strong returns by the materials sector against the backdrop of rising metals prices, with Mexico and Brazil leading the way. In addition to firmer raw material prices, rising crude oil prices have underpinned the Russian market over recent months; both the Russian and Brazilian markets have soared by around 25% in local terms over the last three months.

Elsewhere, the Indian market enjoyed a broad-based rally amid optimism over the country's 2010 economic growth outlook, though the Chinese market's advance was hampered by muted monthly gains from the banking sector amid some concerns that a credit bubble could be developing.

Despite the rising importance of domestic consumer activity in emerging markets, the dollar's ongoing weakness looks set to continue to take some of the shine off the value of emerging countries' exports to the US. Nevertheless, this effect is being partly offset by rising global demand as the economic recovery gradually broadens. The Baltic Exchange Dry Index - a widely-accepted barometer of global trade volumes - set new highs for 2009 during November, recovering further following its collapse in the wake of the global financial crisis just over a year ago.

China is in a strong position to sustain a rapid economic expansion. The country has low levels of public debt and its banking sector has not been directly affected by the financial crisis.

Fixed Income

Following an initial dip, government bond yields moved higher during the month amid fresh signs that the global economic recovery is gaining some traction.

In the US, economic growth for the third quarter was downgraded from 3.5% to 2.8% on an annualised basis, though a closely-watched manufacturing index suggested that the sector has entered a sustainable recovery. Though minutes of a key Federal Reserve meeting suggested that interest rates are set to stay low for the foreseeable future, consumer price inflation topped forecasts. Meanwhile, inflation in the UK ticked higher to 1.5% on a year-on-year basis, topping forecasts as petrol prices rose, and is expected to rise further in the near term as the base effects of tumbling oil prices in late 2008 fall out of the annual calculation. The Bank of England extended its quantitative easing programme by £25 billion, taking the total sum of money created for gilt purchases to £200 billion. Official data confirmed that the eurozone emerged from recession during the third quarter. Amid fresh signs that the region's economic revival is gaining further momentum, speculation grew that the European Central Bank could soon begin to phase out some of the unprecedented measures it has employed to nurse the economy through a period of extreme stress over the last year or so. Though Japan experienced a surprise dip in unemployment, worries over deteriorating government finances and fresh evidence of deflation continued to weigh on sentiment.

Corporate bonds generally extended their outperformance over government debt, though news that Dubai World is seeking to defer interest payments on much of its debt pile weighed on some European financials towards the end of the month. Though we believe that corporate spreads in cyclical areas remain vulnerable to any possible disappointment over the pace of economic growth in 2010, we believe that corporate bonds broadly remain attractive for longer-term investors.

Major Bond Markets – Total Returns £ 2008/2009



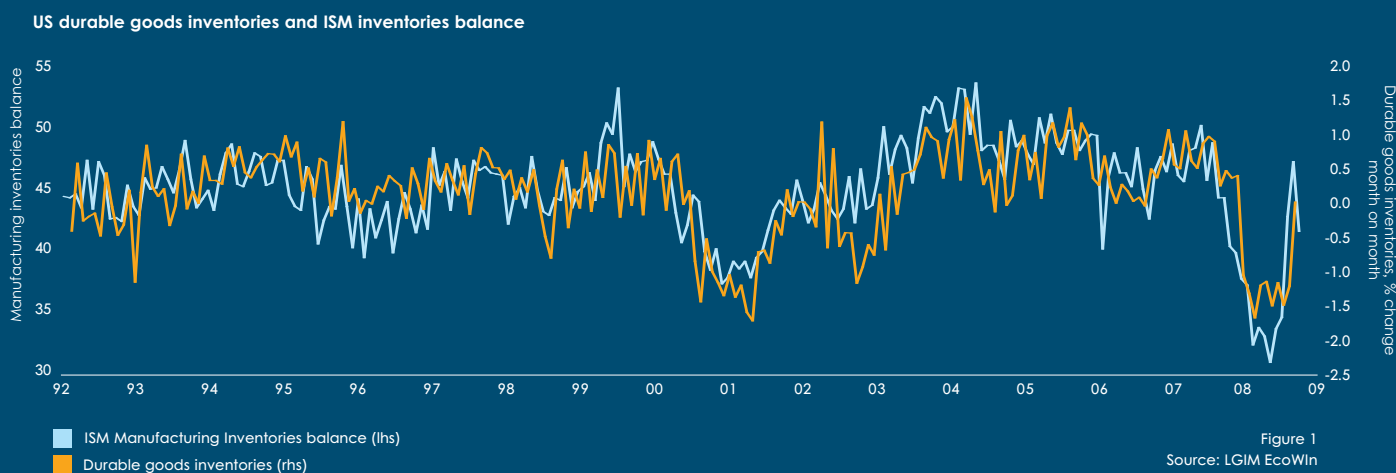
Figure 2
Source: Datastream

Snapshot

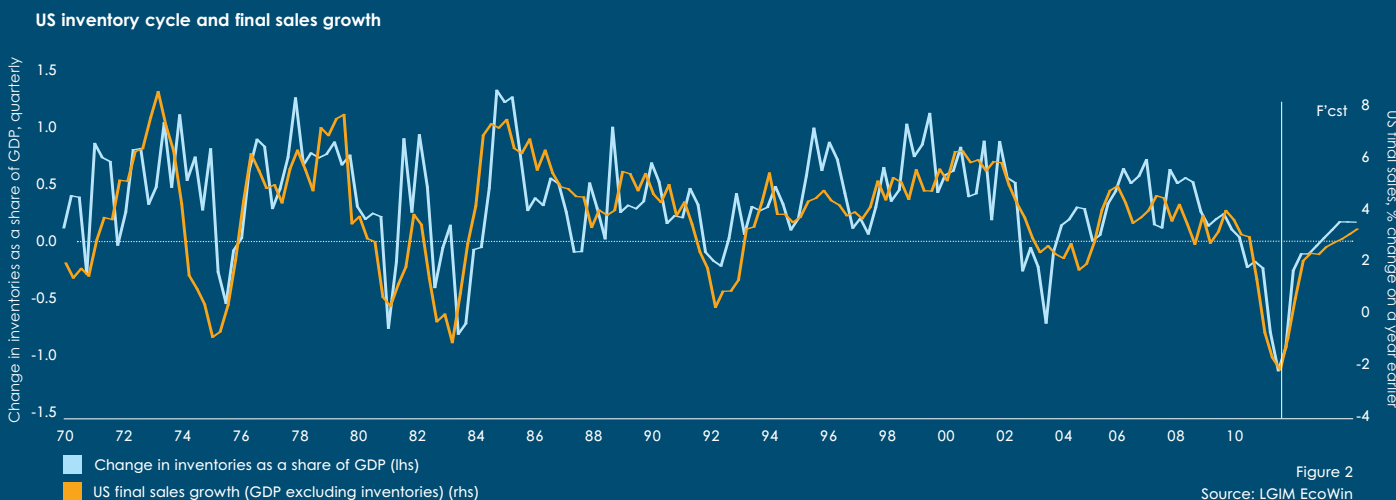
US inventory cycle to boost growth

US companies cut back production aggressively during the financial crisis. Production has begun to recover, but inventories are still being run down at a rapid pace. In 3Q09 inventories declined by \$133bn in real terms (around 1% of GDP), though these figures could be revised in future. This implies there is still a large gap between production and final sales. Destocking will only end if production rises or final sales fall. As we expect final sales growth to be no worse than flat, this implies a few more months of production growth lie ahead. This should be reflected in decent business surveys at least until the turn of the year.

There is a danger that economic data start to disappoint once this inventory effect wears off. To gauge when this is likely we need to monitor carefully the inventories balance with the ISM manufacturing survey. This asks companies whether they are increasing or reducing their inventories. A balance of around 44 has historically been consistent with no change in durable goods inventories. In October the ISM inventories balance moved sharply higher and durable goods inventories stopped falling. But in November the inventories balance fell back, indicating renewed destocking (Figure 1). The increase in the ISM new orders balance also suggests that production will need to rise to prevent inventories falling further.



Durable goods are only a small part of overall inventories and can be quite volatile, but they give us the first indication of shifts in whole economy inventories. We expect the rate of destocking to ease in around the turn of the year. With final sales still relatively subdued, we don't expect companies to add significantly to stocks, but with inventory levels already quite lean, there is no need to deplete them further. The end of destocking should add almost 1% to 2010 US GDP, but on a quarterly basis most of the effect should be over by early next year (Figure 2). There is then a risk that the ISM slips back towards 50. This might disappoint investors looking for further sharp improvements.



UK Forecast

Revisions ahead

UK Economy		Price Inflation (HICP)		GDP (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro	
		2009	2010	2009	2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010
Market participants forecasts		%	%	%	%	%	%	%	%				
	High	2.20	3.50	-4.40	3.30	4.00	5.25	0.50	2.25	1.85	1.95	0.96	1.03
	Low	2.00	1.80	-4.70	0.40	3.30	3.40	0.50	0.50	1.55	1.40	0.84	0.78
	Median	2.10	2.10	-4.50	1.30	3.67	4.43	0.50	1.25	1.66	1.68	0.90	0.85
	Last month median	2.10	2.05	-4.40	1.10	3.75	4.60	0.50	1.25	1.63	1.68	0.92	0.85
Legal & General Investment Management		2.20	2.40	-4.20	2.00	4.00	4.50	0.50	0.50	n/a	n/a	n/a	n/a

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.

Official economic data shows the UK economy contracting by -0.3% during the third quarter of this year. While this was revised up from the preliminary estimate of -0.4%, it is the 6th consecutive quarterly contraction in UK growth. With economic recovery now underway within major developed economies, the UK economy appears to be getting left behind.

However, we believe UK growth will be revised higher still. This is largely due to the fact that while GDP data currently show construction activity in decline through 2009, fresh data now shows it has actually been rising. The data will be revised on December 22. Our view is that the UK economy was actually stronger than official data indicates during mid-2009 and there are likely to be further upward revisions to official data as well as consensus (the median market participant).

We believe we are now approaching the final stage of a square-root shaped recovery. Following the sharp downturn we saw early in 2009, we believe the sharp bounce back from inventory restocking (discussed in the cover article) will begin to fade as we head into 2010 and growth remains subdued as final demand from consumers remains weak. In this environment we anticipate a 2% expansion in the UK economy through the course of 2010. While this is not a bullish forecast by any means, it remains significantly higher than the median market participant's forecast of 1.25%.

Given the anaemic outlook for economic growth and the labour market we do not see any significant underlying inflationary pressures building or any need for the Bank of England to increase official interest rates.

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