



## Indigestion

2007 was a volatile year. Expect more of the same in 2008. Consensus global growth forecasts for 2008 haven't changed all year as stronger emerging economies are assumed to offset a weaker US economy. But rather than heralding a global soft landing, we think it signifies a potential inflationary bust. Inflation forecasts are being revised up again to accommodate yet another 'temporary' oil price shock. History suggests it's unwise to ignore the political repercussions of rising food and energy prices. So regardless of what the Fed does, global policy conditions will have to be tight until we see a significant global slowdown. While equity markets have cheapened, they're not yet priced for a sustained period of sub-trend growth to combat inflation pressures. So we remain cautious over the next year, particularly on the highly indebted Eastern Europe region.

### Inside:

Page 5

**Market Overview:  
Fed opinions may  
change!**

Page 7

**Snapshot:  
UK house prices**

Page 8

**Forecasts:  
Rate Expectations**

I'm sure you're looking forward to a well-earned break over the New Year period. 2007 has been extremely hectic, with most of the action coming over the 'quiet' August holiday period. In the first half of the year, it was dangerous to short any stock as private equity takeover rumours were flying all over the place. But the party ended over the summer as the Bank of England (BoE) and European Central

Bank (ECB) continued to hike rates while the Federal Reserve (FED) maintained an inflation bias.

We warned that interest rates might have to rise more than expected this time last year. We thought the consensus was underestimating the resilience of the UK economy, particularly the spending power of the grey pound and consensus growth

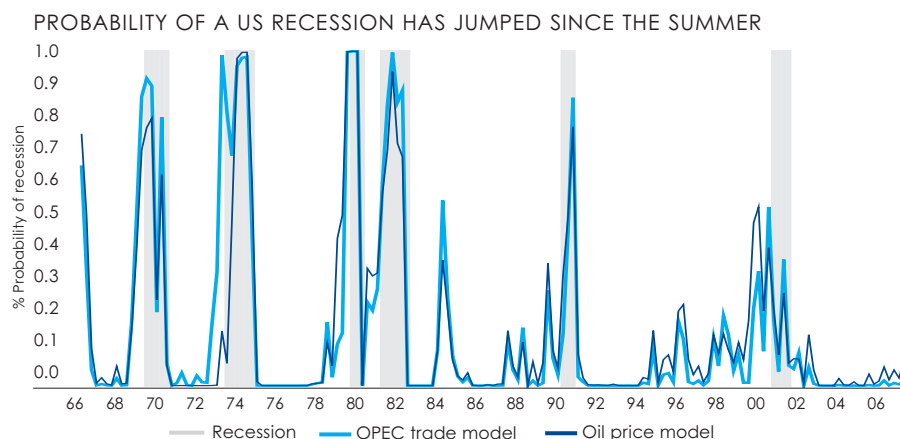
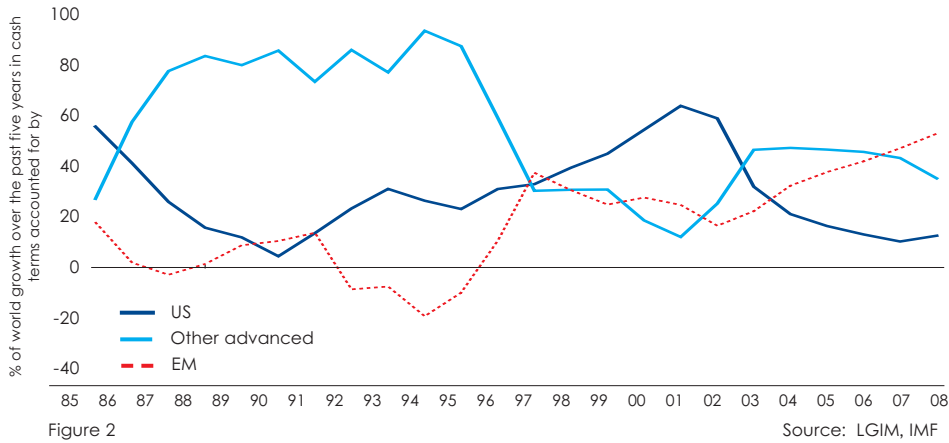


Figure 1

Source: LGIM, Reuters Ecowin

THE US HAS ONLY ACCOUNTED FOR 10% OF THE INCREASE IN GLOBAL CASH GDP IN RECENT YEARS



forecasts would be revised up. We also saw scope for a ‘recoupling’ of the US and euro area economies. We saw weaker energy prices boosting US consumption while higher taxes, exchange rates and interest rates slow Europe down. While we got the economics right – yearly US GDP growth did overtake that in Europe during the course of 2007 – the market didn’t behave as we expected.

We thought the dollar could rebound on a recovery in growth. But we also expected tighter global policy and a shrinking US current account deficit to lead to problems for some emerging markets, leading to a flight to safety. But the crisis was to be found within the US – the sub-prime mortgage sector – so capital flew out of the US into the perceived safety of emerging markets, particularly as the Fed cut interest rates.

And that leads us to the outlook for 2008. We have warned before that policymakers will be slower to cut rates than markets expect. This call proved correct in November when the Fed’s reluctance to cut rates again led to another correction in markets. And we stick to that call now. While we accept that the Fed’s dual mandate (stable prices and full employment) might justify further easing, other central banks will remain tough.

In particular, history warns us against neglecting the political repercussions of

higher food and energy prices. We think inflation has been driven by shortages of capacity. The way to resolve that is through a sustained period of weaker growth. We think consensus growth expectations are inconsistent with a stable inflation outlook. Eventually the global economy must slow below trend. The timing of that slowdown remains uncertain. The People’s Bank of China has less inflation fighting credibility than the ECB for example. But the risk of a slowdown in the future should cause markets to de-rate, leaving markets broadly flat in 2008.

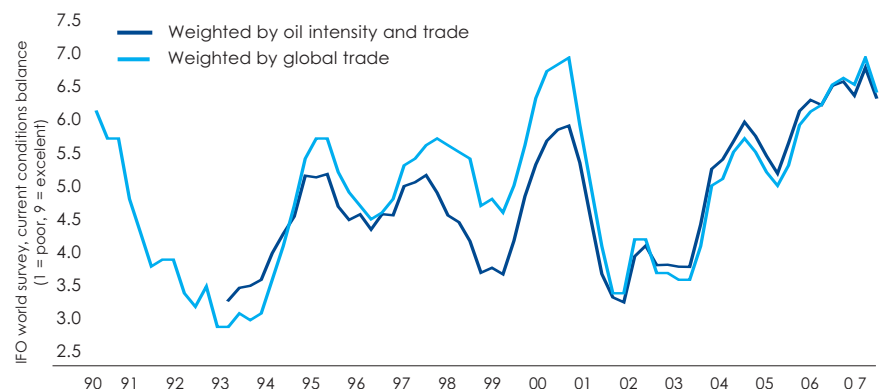
In general, we see the global economy being in the ‘sogflation’ stage of the asset allocation cycle that we highlighted in September’s Fundamentals, “Overfed” (soggy growth, stubborn inflation). There is a risk that the economy enters the ‘ice’

stage – weak growth and falling inflation. This risk is particularly pronounced in the US, where our recession predictor has shot up to around 30% since the summer, reflecting the sharp tightening of lending standards, elevated manufacturing inventory levels and a spike in energy prices (Figure 1). But a sharp collapse in US imports need not push the global economy into recession.

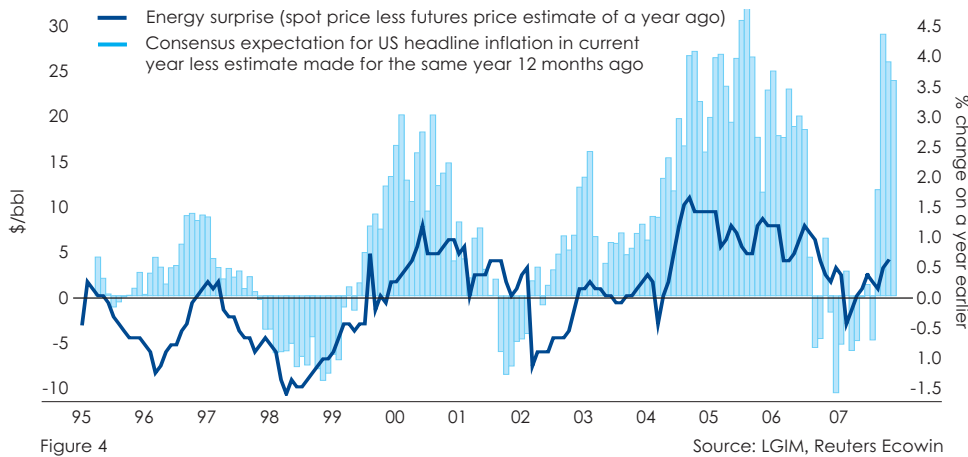
Over the past five years, emerging economies have been a more important driver of global demand than the US consumer (Figure 2). And emerging market bond spreads are still historically low, suggesting domestic investment plans can be maintained. Given the Fed’s dual mandate of full employment and stable prices and that some Fed members still believe energy prices are erratic, the Fed might continue to cut interest rates to stave off a recession. Easier money might continue to find its way into emerging markets, even if banks are reluctant to lend to US homeowners again.

But if the Fed were to successively stabilize global financial markets, this runs the risk of generating a bigger inflation problem in the medium term. We think the probability of a perfect goldilocks soft landing for the global economy (strong growth, low inflation) is low. Central banks agree with us.

ENERGY - WEIGHTED GLOBAL GROWTH IS AT A RECORD HIGH



HIGHER ENERGY PRICES HAVE CONSISTENTLY CAUGHT ECONOMISTS BY SURPRISE



So there are three alternative scenarios for emerging economy central banks. They can either tighten policy by allowing their currencies to appreciate against the dollar and raise interest rates. They can take non-market measures to crack down on lending. Or they risk increasing political unrest. Neither scenario is great for emerging market equities, although at least in the first scenario UK-based investors can benefit from currency appreciation.

Figure 4

Source: LGIM, Reuters Ecowin

Most see upside risks to inflation and downward risks to growth. But the consensus of economists is that the world economy will grow at a solid pace in 2008, similar to the average of recent years. And most are unconcerned about inflation. But we feel the consensus runs the risk of repeating the mistakes of recent years.

We estimate that global economic growth adjusted for oil intensity is currently running at a record high (Figure 3). This explains why oil prices have continued to surprise on the upside in recent years, forcing analysts to revise up their inflation forecasts (Figure 4). We could of course see a favourable supply shock – a dramatic easing of geopolitical tensions or good weather conditions – reducing global commodity prices. But we could just as well see a negative supply shock. This could be especially painful given market conditions are tight. Our measure of global capacity utilization is the highest since 1989 (Figure 5). And if consensus growth forecasts for 2008 are correct, capacity utilisation and inflation pressures are likely to rise further (Figure 6).

History is littered with examples of rising inflation and political revolution. While it's unclear whether Marie-Antoinette did actually say "let them eat cakes" in response to food shortages for French workers, a 60% rise in bread prices in Paris in 1789 did culminate in the storming of the Bastille (see "The Great Wave" by David Hackett Fischer). The Chinese government is no doubt aware of this fact. The Tiananmen Square protests of 1989 occurred after inflation hit 28%. Coincidentally, this is the last official estimate of inflation in Burma, where we have seen significant political unrest in recent months. After noting the pasta protests in Italy, the tortilla troubles in Mexico and the onion objections in India, the head of the International Food Policy Research Institute has warned that the risks of food riots will surge next year as the supply of grain comes under the most pressure in 50 years.

So the countries most vulnerable to a high inflation environment in 2008 are ones with large current account deficits as there is less risk of their currencies appreciating. And, if we do get a global banking crisis, these would also be the countries who will suffer the most from a collapse in bank lending.

Eastern Europe is likely to be the region most severely affected by a lending squeeze in 2008 as it has the highest current account deficit (over 7% of GDP). And as with Asia and Latin America in previous crises, much of their new debt is denominated in foreign currency. But we also have concerns about some surplus countries. Russia for example has a massive oil-related trade surplus but it also has high inflation. Its inflation rate is already 10.8% (compared to a target of 8%) and is set to rise further as pre-election food and energy price freezes expire. High inflation will disproportionately hurt the

So could we get an inflationary boom? The Fed boosts the world with cheap money, global growth remains strong and inflation continues to rise. This is a likely outcome. But not the most likely in our view. We think there will come a point when global inflation pressures become unbearable for the US's trading partners. While most economists like to ignore food and energy prices, most ordinary people do not.

OUR ESTIMATE OF GLOBAL CAPACITY UTILISATION IS AT AN 18-YEAR HIGH

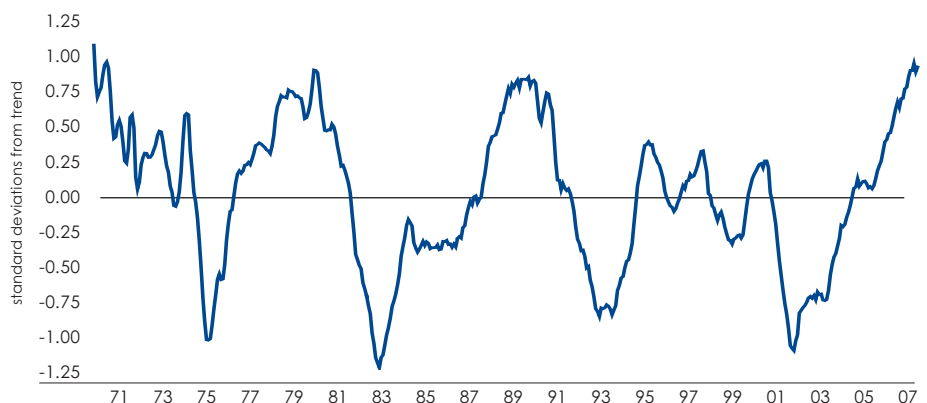


Figure 5

Source: LGIM, Reuters Ecowin

poor and could create political unrest, undermining current investor sentiment that emerging markets are a safe haven from the sub-prime crisis.

Given the sharp increase in global equity market correlations, a crisis in any of these emerging markets could have knock on effects on UK equities just as the problems in US sub-prime mortgages affected global sentiment. So we remain cautious on equity markets in 2008. Consensus earnings forecasts have come down and the Fed is slowly easing policy. But our valuation models suggest markets have not fully discounted the slowdown in activity and profits that we believe is necessary to ease global inflation (Figure 7). So equity markets should again struggle to outperform cash over the next year.

CONSENSUS GROWTH FORECASTS FOR 2008 ARE NOT CONSISTENT WITH EASING INFLATION PRESSURES

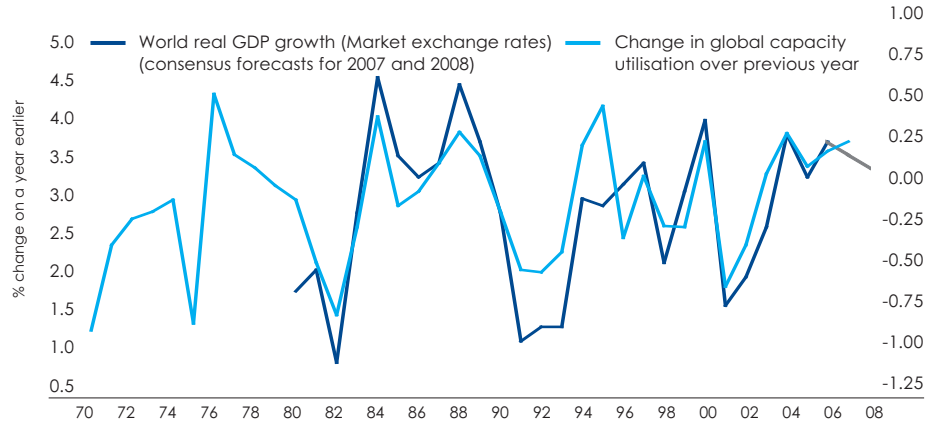


Figure 6 Source: LGIM, IMF, Consensus Economics, Reuters Ecowin

In conclusion, the credit crunch is likely to bite in 2008 as persistent inflation pressures constrain the ability of policymakers to deal with the problems. This increases the risk of a sharp slowdown in the US. A recession in 2008 cannot be ruled out. While credit markets have already corrected to reflect this, equity markets have held up better. So they are vulnerable to an earnings disappointment. We expect US and UK equity markets to come under pressure during the first half of the year. Over the full year we expect the market to move sideways, leaving the FTSE 100 at 6500.

OUR VALUATION MODEL SUGGESTS EQUITIES ARE SLIGHTLY OVERVALUED AFTER ADJUSTING FOR THE ECONOMIC CYCLE



Figure 7 Source: LGIM, Reuters Ecowin Datastream

## Market Overview

# Feds Opinions May Change!

The actions of the Fed cut interest rates again on 31 October but the accompanying statement caused global markets to decline through November. The statement that followed the meeting highlighted upside risks to inflation offsetting downside risks to growth and sent the market tumbling as further rate cuts were looking unlikely and one Federal Open Market Committee (FOMC) member didn't want to cut rates. Worldwide stocks slid downwards and gloom hung over the markets as at one stage the S&P 500 was down over 9% in the month.

In a three-day stint of speeches starting on 26 November, Federal Reserve officials highlighted renewed concern of a deeper credit crunch and all but told the markets that the Fed would cut again to help ease pressure on the stock market. Financials lead a three day 5% rally higher in the S&P500 to month end. Financials were also helped as Citigroup had a \$7.5 billion cash infusion from the Abu Dhabi Investment fund, giving the fund a 4.9% stake in the company, and helping Citigroup to recover from sub prime mortgage write downs, it rallied 15% on this news.

Crude Oil made two attempts to break the \$100 mark in November, failing at its peak at \$99.29 on the back of an unexpected large build in inventories. As a result oil ended the month down below \$90.

### London

#### There may be massive mergers ahead?

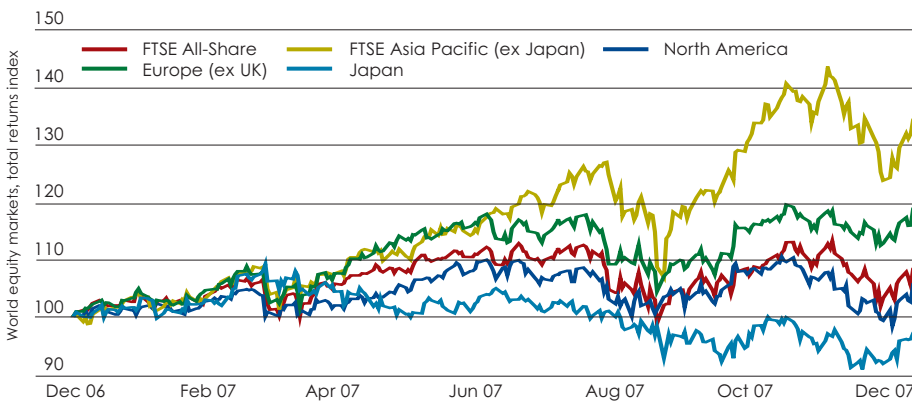
The UK equity market gave back the previous month's gains in November, falling by 4.8% on a total return basis. The mid and small cap indices were particularly weak, with negative returns of -7.8% and -10.9% respectively whilst the blue chip FTSE 100 index performed relatively well with a fall of 4.0%. Growing concerns about a global economic slowdown were very much to the fore. This was reflected in sector performance where classic defensive sectors such as Food Producers, Tobacco and Utilities posted positive gains whilst cyclicals such as General Retailers, Industrial Engineering and Construction experienced sharp declines. The main corporate event was the merger approach for Rio Tinto from their Mining rival BHP Billiton which was swiftly rejected. Elsewhere the bid approach for Sainsbury's fell through. Corporate results were mixed with an increased number of profit warnings from companies such as Pendragon and Paragon. We expect markets to remain volatile in the short term with increased evidence of slowing consumer spending and difficult credit markets impacting on corporate profits.

### Wall Street

#### Only discounts get the US shopping

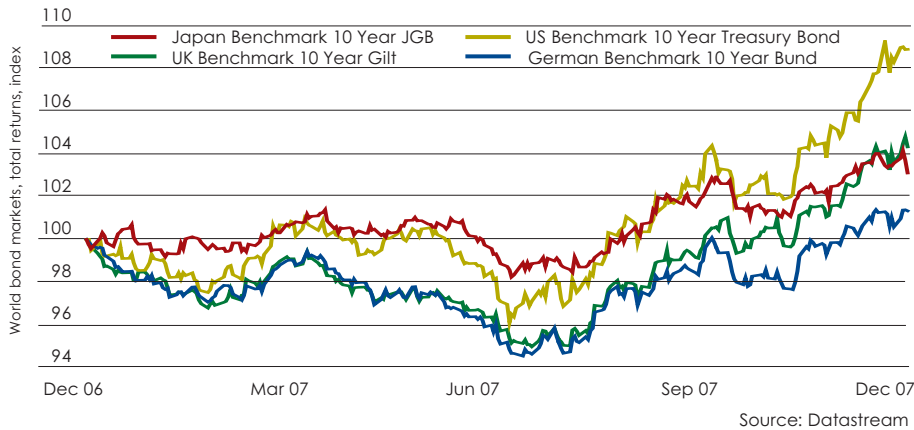
The S&P 500 was down 4.2% in November, its worst monthly performance since December 2002. Information technology and financial stocks were the worst performers. The continued write down of mortgage related securities, rising oil prices and declining earnings estimates set a negative tone for the market through out the period. Holiday sales got off to a slow start and retailers are relying heavily on discounting to shift inventory. Several retailers including J.C Penny and Kohl's Corp posted disappointing results and spoke conservatively about business activity. Cisco Systems posted inline results but raised caution about the pace of financial sector technology spend. This set-off pre-emptive selling in the sector. Economy wide indicators continue to point towards moderation but no imminent GDP recession. Market participants remain concerned about the freezing up of lending activity and its implications for future economic activity. The Federal Reserve has tried to allay some of those concerns by reducing the key rate at two successive meetings and providing liquidity through unconventional channels. These steps have only had limited success and the Federal Reserve may need to be more aggressive to get the desired financial market response. The other issue staring the market in the face is the pace of home price declines and its impact on consumer spending. While forecasts already seem to be building in a fairly pessimistic scenario, the true impact may be magnified if the financial markets remain jammed. We continue to expect a downward trend in earnings estimates for the foreseeable future.

MAJOR EQUITY MARKETS – TOTAL RETURNS £ 2006/2007



Source: Datastream

## MAJOR WORLD BOND MARKETS – TOTAL RETURNS £ 2006/2007



## Europe

### Further bad news from banks expected

November saw a continuation of the concerns in prior months about the state of the world banking sector. Overall, Europe ex-UK markets fell 3.5% in November, although they were down 8.5% at their worst point, before a banks inspired rally in the last 9 days. Boosted by hopes of further cuts in Fed Funds rates in the US and, more specifically, news that Citigroup had raised \$7.5bn in new equity-linked capital from the Dubai Investment Corporation, the European banks sector rallied almost 9% in the last week of the month.

The banks sector is expected to continue to release bad news over coming months as they make further write-downs on their exposures to sub prime mortgages and leveraged loan books. The European sector continues to trade, in aggregate, well above previous trough valuations, on price to book value measures, although one or two are now trading at trough levels.

Focus is increasingly on the risks of contagion from a US recession and on concerns for a continued weak US dollar. European exporting companies have been able to cope with a weak US dollar while their top lines have been rising, but if revenue growth is now threatened by a slowing US and emerging market consumer, the impact of the weak US dollar will become very difficult to deal with. The aerospace, capital goods and auto sectors could look vulnerable in this scenario.

## Japan

### Japan on Fed watch

November was a disappointing month in Japan as companies reported strong profit growth during the first half of the fiscal year but saw little reward from investors. Instead, large write downs by US financial institutions led the Japanese market lower and exporters were sold off as the Yen appreciated against the dollar. Yen strength looks set to continue as the market expects some countries to start diversifying their foreign exchange reserves into non-dollar currencies. Additionally, the market priced in a Fed interest rate cut early in December, which has further negative connotations for exporters and undermines the Bank of Japan's machinations about raising the interest rate, at least in the short-term.

Going into the year end, investors will be wary of any further volatility in relation to the subprime issue and Japanese fund managers will be hopeful of relative outperformance in Japan as company valuations have become extremely compelling.

## Pacific Basin

### PetroChina – “I’m king of the world”

In November the FTSE AW Asia Pacific Index underperformed the world and emerging markets, down 7% in sterling terms. Indonesia was the best performer in the region (+0.2%), Malaysia (+0.1%), and India (-1.3%). The laggards were China (-12.8%), Taiwan (-9.7%), Korea (-8.6%) and Australia (-6.5%).

India found support as the immediate prospect of a general election passed as threats of a no-confidence vote receded. There has also been little selling of foreign investors' participatory notes as this would leave them underweight the country, at a time when many are still going through the Foreign Institutional Investor qualification process.

China was the main underperformer in the region despite PetroChina's A-share IPO, making it the largest stock by market cap in the world. During this period Premier Wen delayed the QDRI program, hurting sentiment, and risk aversion increased in light of demand concerns from the US economy. On the domestic front, inflationary pressure from record oil prices and rising food costs increased. In response the Chinese government hiked the required reserve ratio to a record high of 13.5% to absorb liquidity.

Although we are entering a seasonally strong period, it would appear that the outlook is more balanced with the positive support from further US rate cuts offset by concerns about the impact of a deeper downturn in the US economy and the prospect of more bad news to emanate from the financial sector. For 2008 we believe that any weakening in US consumption will impact economic growth across Asia but to a lesser extent than on previous occasions.

# Snapshot

## UK house prices

The fable of “The boy who cried wolf” teaches us not to tell lies otherwise people won’t believe us when we’re telling the truth. Whenever the Bank of England raises interest rates the newspapers are full of cries of shame from business lobby groups representing the likes of retailers and homebuilders, warning about monetary overkill and an impending slowdown. Similarly, back in early 2005, estate agents cried that the housing market was collapsing. They reported the biggest fall in selling prices since 1992 – a year when house prices fell by around 8%. So how much did house prices fall in 2005? Well they actually rose by 5%. This paradox left economists scratching their heads. How could estate agents report falling prices but in actual fact, prices continued to rise. One theory is that estate agents reported falling asking prices. But some of the previous rise in asking prices didn’t translate into sales. So in a sense, asking prices just came back down to reality. Most economists, including the Bank of England, now look at the sales-to-stocks ratio in the RICS (Royal Institute of Chartered Surveyors) report as a better guide. In Figure 1 we show that the sales-to-stocks ratio remained much higher than it did in the early 1990s, consistent with modest house price gains, rather than a collapse.

RICS SALES TO STOCKS RATIO STILL POINTS TO RISING HOUSE PRICES

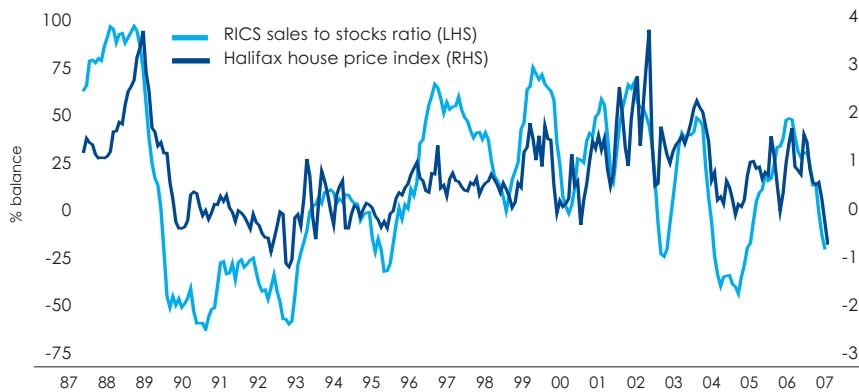


Figure 2

Source: RICS, Halifax

What about 2007? Once again the RICS survey is reporting falling asking prices (Figure 2). But not yet as much as we saw in 2005. And the stocks-to-sales ratio is higher than it got to in 2005. So it’s still consistent with almost double-digit gains. Although demand for property has slumped, a combination of falling unemployment and the introduction of HIPS (Home Information Packs, which requires potential sellers of a home to pay for a survey) is reported to have restrained supply. Scarred by the experience of 2005, we assumed house prices wouldn’t fall until the latter half of 2008. But in fact, the Halifax has reported house prices falling in each of the past three months. The last time this happened was in 1995. What are we to make of this?

LATEST HALIFAX DATA SHOWS HOUSE PRICES FALLING FOR THREE EXECUTIVE MONTHS

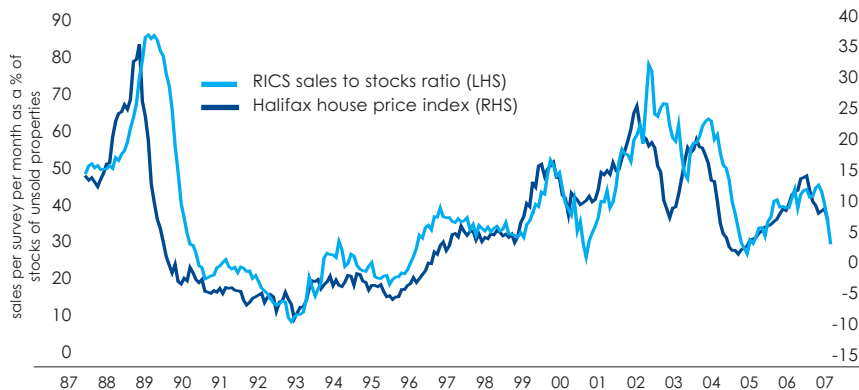


Figure 1

Source: Source: RICS, Halifax

To be cautious, we have assumed house prices fall at an annualized pace of 5% every month in 2008. Model simulations suggest this would knock at least 0.25% off annual GDP growth through a combination of weaker consumer spending, investment and employment. We’ve also taken into account the implications of rising food and energy prices on the UK consumer and global economy and trimmed our growth forecast for 2008 to 2% from 2.4% previously. But higher food and energy prices should keep inflation above target, making the Monetary Policy Committee reluctant to cut interest rates as fast as some people might hope.

## Views Commentary

## Rate expectations

	Price Inflation (HICP)		GDP (Growth)		Earnings (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro		FTSE 100
	End 2007 %	End 2008 %	End 2007 %	End 2008 %	End 2007 %	End 2008 %	End 2007 %	End 2008 %	End 2007 %	End 2008 %	End 2007	End 2008	End 2007	End 2008	End 2008
ABN Amro	2.30	2.20	3.20	2.20	5.50	-	4.95	4.55	5.75	5.25	2.09	2.12	0.71	0.72	6800
Citigroup Smith Barney	-	-	3.20	1.90	4.80	8.70	4.74	4.84	5.50	5.00	2.10	2.04	0.72	0.72	-
CSFB	2.20	2.10	2.80	1.80	-	-	4.60	4.50	5.75	4.75	2.06	0.73	1.84	0.74	7400
Deutsche Bank	-	-	-	1.80	-	8.80	-	4.80	-	5.25	-	1.87	-	0.76	7200
Goldman Sachs	2.00	2.20	2.90	1.60	4.80	5.00	4.80	4.50	5.75	5.00	2.07	1.97	0.70	0.72	-
HSBC Securities	2.00	1.60	2.80	1.40	-	10.00	4.40	4.50	5.75	4.75	2.04	1.83	0.71	0.74	7500
JPMorgan	2.30	2.30	3.10	2.10	-	-	4.51	5.12	-	-	1.84	2.03	0.68	0.67	-
L&G Investment Management	2.10	2.10	2.80	1.80	6.00	4.00	4.80	4.70	5.50	5.00	2.04	2.10	0.72	0.72	6500*
Merrill Lynch	2.30	2.00	3.10	2.10	5.00	6.00	-	4.50	5.50	5.00	2.06	1.95	0.71	0.76	6890
Morgan Stanley	2.20	2.00	3.00	1.90	6.00	-	4.90	5.30	5.50	5.25	2.13	1.96	0.71	0.69	6300
UBS	2.10	2.00	3.10	1.80	5.70	6.30	4.80	4.80	5.75	5.00	2.01	1.90	0.69	0.72	7200
Median (ex L&G Inv Mgt)	2.20	2.05	3.10	1.85	5.25	7.50	4.77	4.68	5.75	5.00	2.06	1.96	0.71	0.72	7200
Last Month	2.00	1.90	3.00	2.05	5.80	8.00	4.93	4.90	5.75	5.25	2.03	1.89	0.70	0.72	7200
Actual end :															
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
2004		2.50	2.60		6.71		4.53		4.75		1.92		0.71		4814

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.

Respondents have not had sufficient time to lower their 2007 base rate from the median expectation of 5.75% to the current 5.5% actual after the rate cut decision of 6 December. They have although managed to lower this month their expected 2008 base rate from 5.25% to 5.00% as they expect the Bank of England (BOE) to follow the US FOMC in lowering base rate housing weakness continues.

Once again Gilt yields have been revised down as bond markets continue to be affected by credit concerns.

Further write downs by US banks again this month have forced another decline in expected 2007 earnings and the lowering of 2008 forecasts indicating our respondents expect earnings to remain under pressure next year.

Sterling forecasts put the pound stronger against the dollar going forward this month but weaker this month against the euro.

We have revised down our UK GDP for 2008 to 2.0% from 2.4%. This is because recent data suggest house prices have started falling, even though the RICS (Royal Institute of Chartered Surveyor) report's sales-to-stocks ratio remains consistent with further house price gains. We have made a cautious assumption that house prices fall by 5% in 2008. See snapshot for more details. This, combined with the impact of higher food and energy prices, should subdue growth. We have changed our base rate and gilt forecast accordingly. But we have actually revised up our inflation forecast based on higher food and energy prices. We have also revised down our FTSE 100 forecast to 6500 as weaker growth and stubborn inflation should make it difficult for markets to make further gains.

For further comment on Fundamentals, or for additional copies, please contact Harriet Moore at [harriet.moore@lgim.co.uk](mailto:harriet.moore@lgim.co.uk)  
For all IFA enquiries or for additional copies, please call 0845 273 0008 or email [cst@landg.com](mailto:cst@landg.com)

#### Important Notice

This document is designed for our corporate clients and for the use of professional advisers and tied agents of Legal & General. No responsibility can be accepted by Legal & General Investment Management or contributors as a result of articles contained in this publication. Specific advice should be taken when dealing with specific situations. The views expressed in Fundamentals by any contributor are not necessarily those of Legal & General Investment Management and Legal & General Investment Management may or may not have acted upon them and past performance is not a guide to future performance.

The FTSE UK Indices are calculated by FTSE International Limited ("FTSE™"). FTSE™ does not sponsor, endorse or promote these funds. All copyright in the indices' values and constituent lists belong to FTSE™. Legal & General Investment Management Ltd. has obtained full licence from FTSE™ to use such copyright in the creation of these funds.

™FTSE™, "FT-SE®" and "Footsie®" are trade marks of the London Stock Exchange Plc and The Financial Times Limited and are used by FTSE International Limited ("FTSE™") under licence. "All-Share" is a trademark of FTSE™.

© 2007 Legal & General Investment Management Limited. All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, including photocopying and recording, without the written permission of the publishers.

Legal & General Investment Management Ltd, One Coleman Street, London, EC2R 5AA  
[www.lgim.com](http://www.lgim.com)

Authorised and regulated by the Financial Services Authority