

Removing the stabilisers

The UK economy is about to embark upon a period of the greatest fiscal policy tightening since the Second World War. In early 2008, LGIM's 'UK recession indicator' was flashing red-alert and the concern proved to be warranted. With the deep recession of 2008/2009 still fresh in our minds, the prospect of removing the automatic stabilisers of government spending and lower tax bills poses some serious concern. Government figures suggest this hit to growth will be offset by the biggest private sector boom ever. However, in this edition of Fundamentals, LGIM Economist James Carrick argues this is overly optimistic given the weak health of the banking sector and risks the UK falling back into recession by 2012. Given the extent of government spending cuts and tax increases (fiscal tightening) ahead, James argues that the Bank of England will have to keep interest rates unchanged all through 2011 and possibly increase Quantitative Easing (QE) to reduce the value of sterling and help support the economic recovery.

Too young?

The UK recession officially ended in the fourth quarter of 2009 – the same time my son was born. I have already decided on his Christmas present – he will be getting a bicycle. However, I am naturally concerned about his safety. So

in fact, he will be getting a three-wheeled 'trike' to ensure he doesn't fall over. By contrast, the new coalition government is confident the not yet one-year old UK economic recovery can remain upright even if the so-called 'automatic stabilisers' are removed suddenly.

In our May 2008 edition of Fundamentals ('Recession Alert') we warned there was a severe risk of a UK recession in the following year. With fiscal tightening imminent, we have refreshed our model. It currently suggests only a 10% chance that year-



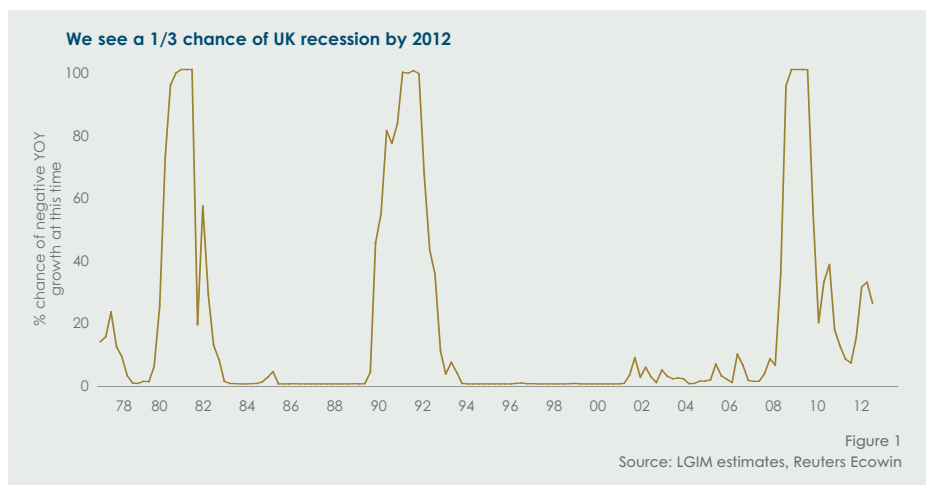
Inside:

Market Overview

Snapshot: Slow recovery in US housing ahead

UK Forecast: Growth forecast cut as UK braces for austerity

Article Contd.



on-year growth is negative in a year's time. However, this probability rises to around 33% for 2012 (Figure 1). Given that this is a 'year-on-year' forecast, it implies that the economy may begin to contract as we head through 2011.

Government borrowing automatically rises during a recession (Figure 2). This is because the income the government receives from taxes falls as it is primarily linked to profits, income or spending, rather than a fixed amount per person (poll tax). At the same time, government spending on welfare also rises as unemployment increases. This explains why government borrowing soared from 2.4% of GDP in 2007 to 11% in 2009.

A sharp rebound in economic activity and asset-market turnover would shrink the deficit. But this is a gamble the gilt market might not allow the government to take. Anxious to avoid a Greek-style meltdown in the gilt market, the government plans to cut spending and raise taxes on a scale not seen since the Second World War. We're concerned that the recovery is not yet strong enough to cope with such a rapid removal of the automatic stabilizers which have supported the economy during the recession.

Reverse engineering the budget

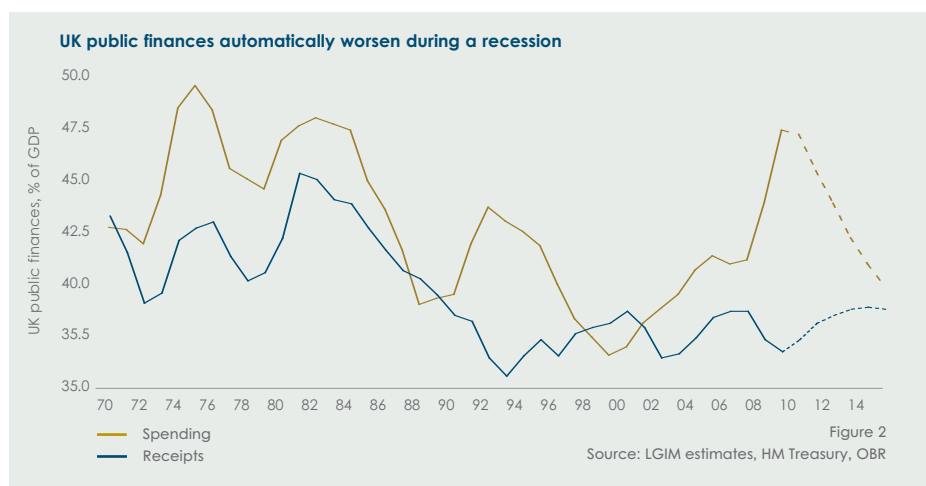
We believe the government's growth forecasts are too optimistic as they suggest the biggest ever private-sector boom. Figure 3 highlights the unprecedented scale of fiscal tightening the government intends to implement. It shows the contribution to annual real economic growth from government spending and tax changes since 1976.

Normally, increases in government spending (which account for around half of the economy) contribute just over one percentage point to economic activity. Over the next four years however, the government will contribute on average minus 0.75 percentage points. So the private sector (the other half of the economy)

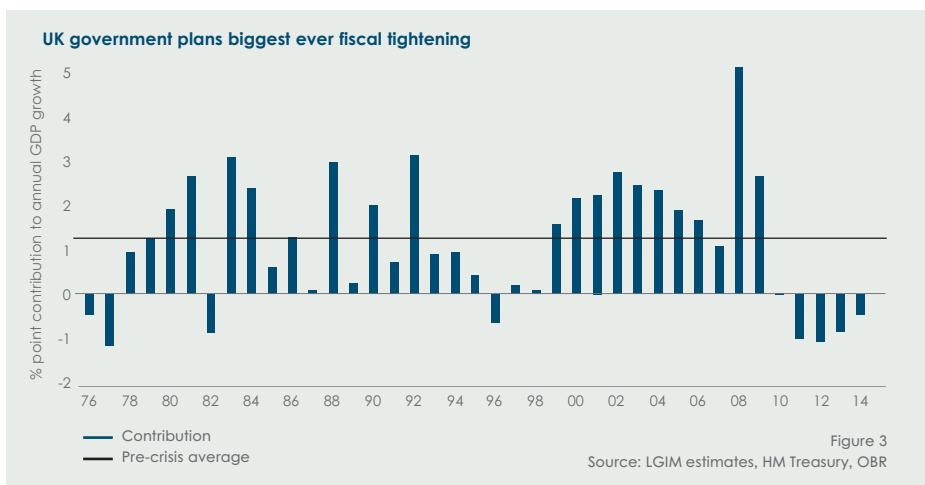
will need to contribute an extra 1.75 percentage points to growth than normal in order to keep overall economic growth close to trend. The government actually assumes that overall economic growth will be slightly above average during the following four years. This implies that the private sector will need to expand by around 6.5% on average over the next four years compared with a pre-crisis average of 2.25%. Clearly this is optimistic! In fact, it is faster than achieved during the deregulation boom-and-bust of the late 1980s and the tech-bubble of the late 1990s.

It is not unreasonable to expect strong private-sector growth in the near term. As we have discussed before, companies cut output below sales in 2009 in an attempt to run down unsold inventories. As inventories are now lean, companies are raising production back in line with sales. Moreover, many companies slashed investment during the recession. It is likely that investment spending recovers to replace/repair assets that have depreciated, particularly technology equipment.

But a recovery is not the same as an expansion. Just because output is improving from artificially depressed levels doesn't mean it's about to break



Article contd.



new highs. A sustained 6.5% per annum rise over four years requires a large improvement in confidence and – in our view – credit availability.

Tight credit

In Figure 4 we show how difficult it currently is for companies and households to get a loan. We estimate that credit conditions in the US are currently the most restrictive ever. It was as easy to get a loan at the peak of the housing mania in 2006 as it was during the peak of the tech bubble in 1999. But it is now far tougher to get a loan than it was during the depths of the tech bust in 2003. Indeed, we estimate it has never been this difficult to get a loan in the US since data began in the late 1967. The Bank of England has only collected data on UK credit conditions since 2007 but there is no evidence to suggest that the UK situation is any different from the US.

This is important because, in our view, credit conditions could constrain the recovery in the private sector. If credit remains tight, mortgage lending should remain depressed. This should dampen house price inflation, which in turn should have a knock-on effect on housing investment and consumer spending on durable goods.

Weak credit availability could also constrain business investment. Not only could it prevent existing companies from expanding but it is likely to prevent new businesses from starting up.

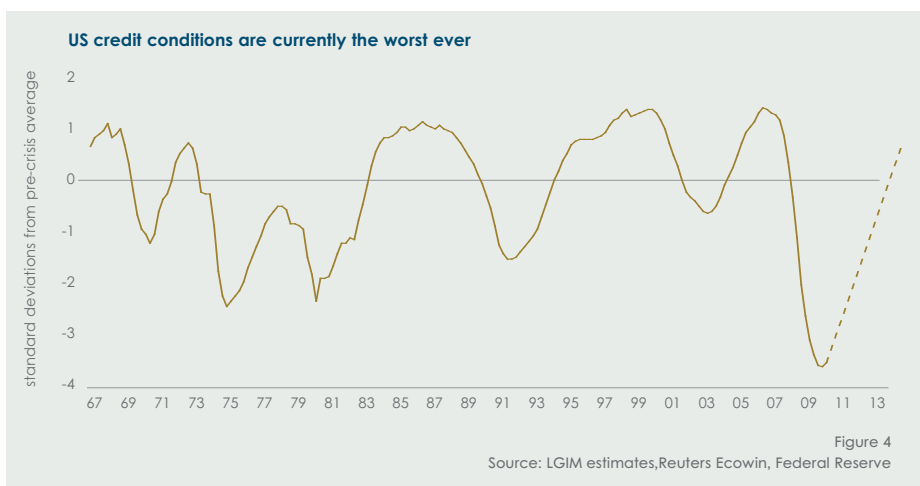
Academic research presented by ex-MPC member Danny Blanchflower suggests house price inflation facilitates small-business formation. The Bank of England has also suggested that tight credit could be preventing UK companies from taking advantage of the weaker pound to expand into new markets.

If it is true that the level of credit availability restricts economic activity, then private sector growth could be significantly weaker than the government predicts.

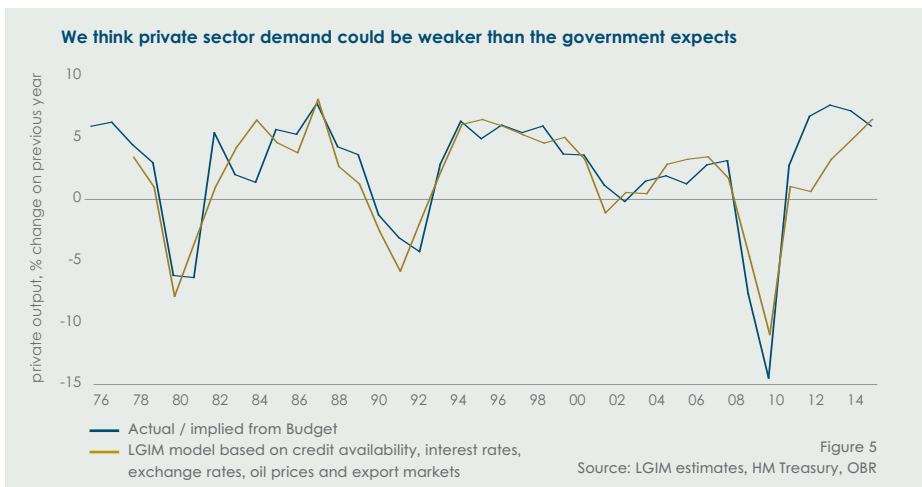
In Figure 5 we try to forecast private sector growth using a variety of macroeconomic factors – the level and change in credit conditions, energy prices, exchange rates, interest-servicing burden and export market growth. Even if we assume credit conditions improve at a rapid pace, the model suggests private sector growth will be subdued until 2014 when credit conditions should become ‘easy’ again.

This analysis clearly suggests there are downside risks to growth between now and 2014. But it’s also unclear that credit conditions will improve as rapidly as our stylised scenario suggests. A measure of Japanese credit availability has never returned to the easy conditions seen in the late 1980s (Figure 6).

Credit conditions have historically moved in line with bank charge-off rates. When there are fewer bad debts, banks have more money for new lending. This explains why economic cycles can be excessively amplified. In good times of falling unemployment and rising house prices, banks are encouraged to lend more, further pushing down unemployment and boosting house prices. The danger is that rapid fiscal tightening keeps



Article contd.



unemployment high which in turn discourages banks from lending. Sovereign default risk in Southern Europe is also likely to make banks cautious about lending.

Policy options – currency debasement?

What are the alternatives? Our model for private sector demand assumes the Bank of England keeps interest rates at just 0.5%, so clearly further rate cuts are not an option. But the model also assumes the exchange-rate remains unchanged. It is therefore possible that the Bank of England could try to further reduce the value of the pound by expanding Quantitative Easing. As well as boosting exports, a weaker pound should also speed up the rebalancing of the economy as expenditure would switch towards domestically-produced goods and services away from more expensive foreign ones. The problem is that policymakers in the euro area and the US also want a weaker currency. We could well see a period of competitive devaluations through monetary expansion.

In extreme, a loss of confidence in reserve currency paper money could lead to a surge in import prices – particularly commodity-related – which could lead to a sharp rise in consumer

price inflation as consumers and firms hoard goods. This would have painful consequences, but if nominal wages were to rise in response it would at least ease the debt burden of the household and government sector.

The alternative extreme is Japanese-style deflation. Fiscal tightening keeps unemployment high, credit conditions remain tight, prices and wages fall and debt burdens continue to rise. The government has to make even more cuts in spending to stabilise debt and so on.

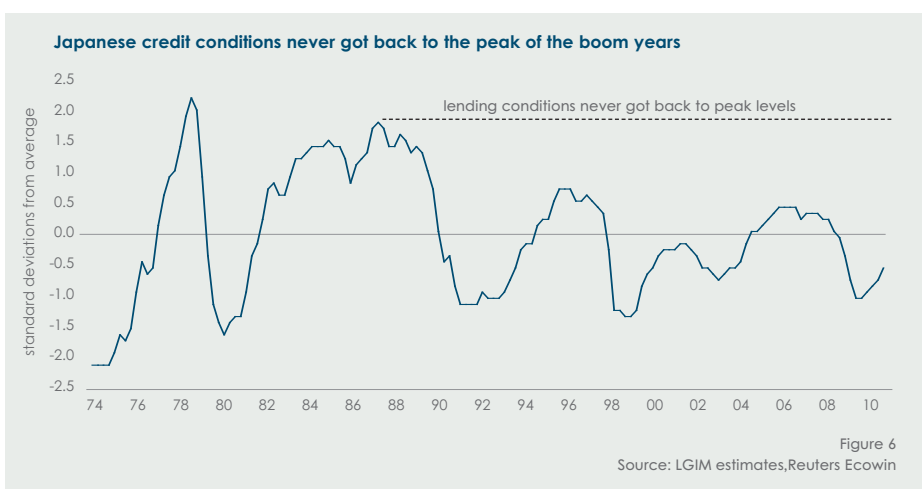
More cautious than consensus

The government expects that the economy can avoid these two extremes and maintain a stable path

of solid growth and modest inflation. But just as I don't think my son is ready to ride a two-wheeled bike, I don't think the economy is strong enough to take away the support from government 'automatic stabilisers'.

The Bank of England will need to provide offsetting support to the economy. Therefore, we expect the base rate to remain unchanged at just 0.5% throughout 2011 compared with consensus' expectation of a rise to 1.75%. The Bank of England will want to make sure the pound does not rise further. A danger is that fiscal tightening makes the pound a more credible currency than the euro or US dollar, undermining the export recovery. Low interest rates should also boost the profitability of bank lending, helping to improve credit conditions.

If keeping interest rates unchanged at 0.5% does not prove sufficient then we could see more quantitative easing. Moreover, we would not be that surprised if the UK government's appetite for fiscal consolidation eventually fades in the face of persistently high unemployment. The bottom line? The economy is likely to be less stable than the government and many investors expect.



Market Overview

Global stock markets ended June firmly in the red. Investors appeared nervous that slowing western economic recoveries are set to drag on corporate earnings growth. With Europe increasingly forcing down the bitter pill of state austerity, concerns abound that cuts could even derail the still-fragile recovery. European markets endured exceptional levels of mid-month volatility amid uncertainty over the results of the forthcoming bank stress tests. Rising LIBOR rates reflected a mood of uncertainty reminiscent of the atmosphere of fear and suspicion that swept the global banking industry in the aftermath of the Lehman debacle of September 2008.

While many developed economies seek to perform a difficult balancing act by supporting their feeble recoveries while at the same time retaining the confidence of investors in the health of their national finances, the emergent economic titans of China and Brazil continue to swagger. However, such is the mood of uncertainty among many investors at present that concerns abound over whether China can cool its overheating economy without giving the rest of the world a chill.

Equity Overview

UK

Belt-tightening begins

The emergency budget confirmed expectations that action to tackle the £155bn deficit will be funded mainly from spending cuts rather than tax increases. The belt-tightening measures announced were largely as expected, with a virtual public sector pay freeze, a bank tax and squeeze on welfare, notably housing benefits. There was some surprise that VAT was raised by a full 2.5% to 20%, though the government's bold actions were generally well received by investors.

The latest Public Sector Borrowing Requirement (PSBR) numbers were slightly better than expected, while the Office for Budget Responsibility reported that the budget deficit could be £20bn less than forecast by 2015. House price surveys painted a mixed picture, though property bears got their teeth into signs of stagnation in new mortgage lending. Though May's CPI dipped more than expected, to 3.4% from 3.7%, one member of the Bank of England's Monetary Policy Committee broke ranks by voting for a rate increase.

UK equities – as shown by the FTSE All-Share index – declined -4.6% during the month. In sector terms, cyclicals struggled, with basic materials and construction among the greatest areas of weakness. Worries over the Gulf fiasco's impact on BP dragged oil & gas stocks lower. However, defensive sectors outperformed, with utilities, telecoms and healthcare delivering positive returns.

EQUITY OVERVIEW

as at 30 June 2010

| Total return (denominated in £) | June (monthly) return % | Calendar year-to-date (6 months %) return % |
|---------------------------------|-------------------------|---|
| UK | -4.6 | -6.1 |
| US | -8.0 | 0.8 |
| Europe | -3.0 | -11.0 |
| Japan | -4.8 | 5.4 |
| Asia | -3.0 | -2.2 |

Source: Datastream, FTSE® indices shown

Major Equity Markets – Total Returns £ 2009/2010



Figure 1
Source: Datastream, FTSE® indices shown

US

Recovery hits softer patch

A second revision to first quarter GDP figures signalled that the US recovery is faltering. The original 3.2% estimate was downgraded to 2.7% annualised quarter-on-quarter, largely due to a marked slowdown in previously-buoyant consumer spending. The employment market has also yet to show any real signs of improvement after three full quarters of economic growth; May's non-farm payroll data disappointed when temporary census hiring-related distortions were removed. Consumer confidence fell while there were signs that the recent recovery in the housing market could be petering out. Though the S&P/Case-Shiller price index rose marginally, new home sales plummeted as tax credit incentives were withdrawn.

As evidence mounted that the recovery in the world's biggest economy is losing some momentum, the Federal Reserve reaffirmed that interest rates are set to remain on hold for an "extended period". Indeed, some regional Fed officials' musings that a combination of economic recovery and inflation have more recently been countered by talk of the deflationary threat of a jobless recovery as the lavish level of economic stimulus gives way to the new age of austerity across much of Europe.

US equities, as measured by the FTSE All-World North America index, tumbled by -8.0% for sterling-based investors. Consumer discretionary stocks, industrials and materials were among the worst performers while defensive sectors such as healthcare, telecoms and utilities fared relatively well.

EUROPE

Getting stressed over banks

Extreme nervousness was the dominant theme across European markets in June. Still anxious over how big an impact the 'peripheral' Eurozone sovereign debt crisis will have on the fragile economic growth of 'core' countries such as Germany and France, European investors closely monitored developments within the banking sector. Though the results – due by late July – of the Spanish banking sector will fall under particular scrutiny, there was at least a glimmer of hope that the European banking sector may be in slightly better overall shape than some had feared. ECB data showed that banks had made less use of a 12 month liquidity scheme than had been expected, though the bank emphasised that it remains very vigilant over risks in the sector.

Despite the wider fallout from the sovereign debt debacle, 'hard' economic data from the Eurozone was surprisingly solid,

Equity Overview Contd.

suggesting that some consumers and businesses remain ‘decoupled’ from the financial industry’s woes, for the time being at least. Eurozone economic sentiment rose slightly with consumer confidence also holding steady. June’s Purchasing Managers’ Index topped expectations, while year-on-year Eurozone economic growth for the first quarter was even revised up to 0.6% from the earlier 0.5% estimate.

European equities, as indicated by the FTSE AW – Developed Europe (ex UK) total return index, lost -3.0% in sterling terms over the month. Amid signs that the global recovery is stuttering, cyclical sectors such as steel makers performed badly while defensive sectors such as tobacco and health care outperformed.

▶ JAPAN Modest recovery continues

Economic headlines from Japan were very much a mixed bag in June. Though first-quarter economic growth was revised up marginally to 5.0% annualised compared to the previous three months, concerns rose that a more recent dip in retail sales and household spending could remove important props to the country’s nascent domestic economic recovery.

Unemployment data were met with disappointment as the rate picked up to 5.2%, suggesting that, much like the US,

Japan’s recent economic recovery has yet to have any meaningful benefit for jobseekers. Nevertheless, the Bank of Japan noted that the country’s export-led recovery is expected to continue, albeit with the Eurozone’s sovereign debt woes likely to have at least some impact on global demand. On the political level, Finance Minister Han took over as Prime Minister after previous incumbent Yukio Hatoyama resigned after taking the flack for the slump in the government’s popularity. The government announced its intention to tackle Japan’s huge national debt pile, boldly planning to bring the budget into the black within a decade. However, the ‘detail-lite’ pronouncement received a lukewarm rating agency response, with Moody’s noting that Japan could yet face the prospect of a downgrade should it stray from the path of budget virtue.

Japanese equities, slid in line with their international counterparts in June, with the FTSE AW – Japan total return index slipping by -4.8% in sterling terms.

▶ ASIA/EMERGING MARKETS Emerging faster than ever

China finally responded to international pressure for more flexibility in its exchange rate policy. With news that the yuan is to be managed against a basket of currencies, the currency strengthened slightly. However,

China’s policy tweak is unlikely to appease those demanding that the yuan floats to a level that fully removes a key advantage for Chinese exporters. Investors await with keen interest the extent to which the runaway property market will be affected by tighter restrictions on lending and multiple home purchases. May’s robust export data failed to reflect any early impact on demand from the West’s softening recovery. Though China’s latest inflation numbers broadly met expectations, increases in wages approved by some manufacturers and regional governments in responses to disgruntled workers’ sabre rattling raised the prospect that factories could look to pass on higher costs over the medium term.

Meanwhile, data showed that the Brazilian economy is growing at a scorching pace, with year-on-year expansion of 9.0% during the first quarter. Driven by the strength of the agriculture and industrial sectors, this represented the economy’s best performance in at least 14 years.

Elsewhere data showed that India’s economy grew by an impressive 8.6% during the first quarter compared to a year ago, while the IMF predicted that the Brazilian economy is on course for growth of 7% this year, underlining the important role that emerging economies are playing in supporting the global economy as some developed economies begin to falter.

Fixed Income

With the turmoil in peripheral eurozone bond markets and signs that the developed markets’ recoveries are softening, numbing investors’ appetite for risk, most major government bond markets continued to benefit from their ‘safe haven’ status. Yields fell sharply in the US and the UK, while investors’ loss of confidence in Spain, Portugal and Greece were reflected in higher yields, with the latter hit by a hefty four-notch downgrade by Moody’s as the agency cited uncertainty surrounding the EU/IMF rescue package. Even in ‘core’ Eurozone countries, investors pushed the 10-year yield spread between French and German debt from 0.26% to 0.48% over the month amid jitters over looming bank stress test results. Though Germany’s public sector landesbanks were previously vocal critics of plans to publish the test results and the Bank of Spain recently bounced a floundering regional ‘caja’ into a takeover, corporate bonds investors have drawn comfort from the reassurances that state assistance will be made available to any banks requiring recapitalisation.

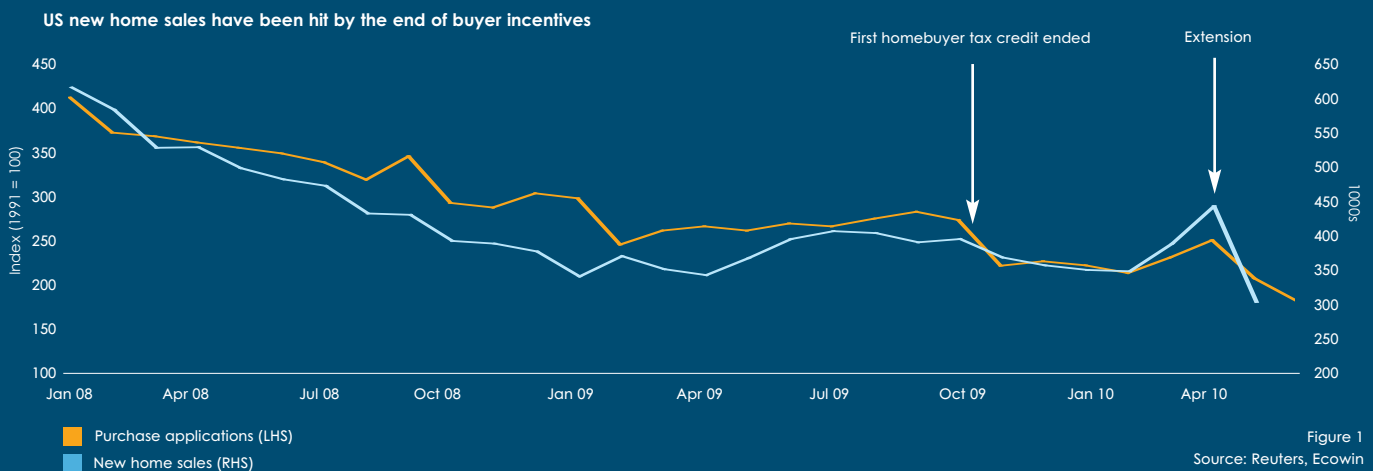
Major Bond Markets – Total Returns £ 2009/2010



Snapshot

Slow recovery in US housing ahead

US new home sales plunged to a new low of only 300k in May, triggering fears of another leg down in the US housing market in the months ahead. This followed the expiry of the \$8000 first-time homebuyers' tax credit at the end of April. This incentive had already been extended and made more generous after it first ran out at the end of November last year. At present there are no plans for any additional support beyond the existing loan modification schemes and allowing more time for those who signed a contract before the end of April to complete their purchase. Mortgage purchase applications, which are released on a weekly basis, suggest June home sales are unlikely to see any improvement (Figure 1). The current weakness in demand has negative implications for residential investment, house prices and could further undermine bank balance sheets and consumer confidence.



It is now clear that the improvement in home sales seen in the spring was somewhat artificial and only reflected demand brought forward. As the tax credits ended, home sales have fallen sharply. This is the same pattern witnessed following the end of the 'cash for clunkers' programme. Car sales collapsed in the aftermath, but have subsequently been slowly recovering (Figure 2). Home sales could follow this path. Home sales are now incredibly depressed, running at a rate far below household formation which in a normal year is in excess of one million. Housing affordability also appears cheap as prices have fallen on average around 30% from their peak and mortgage rates are historically low, having declined further in recent weeks.



There are still many headwinds which are likely to make any recovery gradual. Tight credit conditions and poor labour market conditions will make it hard for many families to qualify for a loan. The outlook for house prices will also act as a deterrent. There is still a glut of unsold properties on the market and banks have been slow to move delinquent homeowners into the foreclosure process. As these properties hit the market, this could potentially depress prices further. At least homebuilders are no longer adding to the excess supply as housing starts are exceptionally low. Overall, we think the tax credit expiry hangover will mark the low for new home sales, but recovery is likely to be gradual and housing will lag the overall economy rather than offer its usual leadership following a recession.

UK Forecast

Growth forecast cut as UK braces for austerity

| 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 2010 | End 2011 |
| Market participants forecasts | % | % | % | % | % | % | % | % | | | | |
| High | 3.30 | 3.70 | 1.70 | 3.30 | 4.70 | 5.10 | 1.00 | 2.50* | 1.65 | 1.66 | 0.89 | 1.00 |
| Low | 2.50 | 0.90 | 0.90 | 1.20 | 3.10 | 3.40 | 0.50 | 0.50* | 1.31 | 1.27 | 0.76 | 0.75 |
| Median | 3.10 | 1.90 | 1.20 | 2.00 | 3.93 | 4.80 | 0.50 | 1.25* | 1.46 | 1.52 | 0.80 | 0.78 |
| Last month median | 3.10 | 1.90 | 1.20 | 2.25 | 4.50 | 4.42 | 0.50 | 1.75* | 1.44 | 1.50 | 0.83 | 0.80 |
| Legal & General Investment Management | 3.00 | 2.70 | 1.50 | 1.30 | 4.50 | 5.00 | 0.50 | 0.50 | 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 have revised our UK GDP forecasts lower this month. The global economy is slowing as world trade and production begin to normalise after the boost received from the 'inventory rebound' which followed the deep recession of 2008/09. We believe government spending cuts and higher taxes are likely to cause UK GDP to be significantly lower than the median market participant suggests for 2011. This month we revised our GDP estimate for 2010 from 1.6% to 1.5% and our 2011 forecasts from 1.9% to 1.3%.

Despite our weaker outlook for UK economic growth than consensus, we believe that inflation will remain high for an extended period of time due to weak productivity, the increase in Value Added Tax (VAT) and the possibility of further Quantitative Easing (QE) to offset the detrimental effects of the tighter fiscal policy. Our model suggests inflation will remain around 2.7% in 2011. The median market participant anticipates a reading of 1.9%. Given weak growth and the austerity measures announced by the government, our official interest rate model is not suggesting any need for rate hikes this year or next.

For further information on Fundamentals, or for additional copies, please contact Kate Morley at kate.morley@lgim.co.uk

For all IFA enquiries or for additional copies, please call 0845 273 0008 or email cst@landg.com

For an electronic version of this newsletter and previous versions please go to our website <http://www.lgim.com/media-centre/fundamentals.shtml>

Important Notice

This document is designed for our corporate clients and for the use of professional advisers and 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.

"FTSE®", "FT-SE®", "Footsie®", "FTSE4Good®" and "techMARK" are trade marks jointly owned by the London Stock Exchange Plc and The Financial Times Limited and are used by FTSE International Limited ("FTSE") under licence. "All-World®", "All-Share®" and "All-Small®" are trademarks of FTSE."

© 2010 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

Authorised and regulated by the Financial Services Authority