



The yield compression chamber

Financial markets are mad for yield and it is not hard to see why. Many yield based assets from emerging market debt to global REITS have sharply outperformed their respective markets. In this issue of *Fundamentals* Julien Garran and Emma Brandwood, LGIM's strategists, ask what has caused these trends, who has been buying and selling and what implications this has for future investment decisions.

If we were to characterise the dominant trend in financial markets over the past four years with a phrase, that phrase would be 'the global hunt for yield'. We've seen high yielding stocks outperform those with low yields for much of the last four years. We've seen high yield credit outperform AAA. We've seen high yielding emerging market debt outperform developed world debt. We've seen REITS outperform equities. In every battle for financial performance, markets have had to yield to yield!

What caused these trends? Will financial markets remain 'in the yield compression chamber' or will we see a turn in the trend?

In our view the entire story stems from the extraordinary confluence of strong global growth but low global bond yields.

This has set up the desire to hunt for yields in risky markets. But why are bond yields so low when growth is so strong?

Enter the conundrum

In 2005, Fed Chairman Alan Greenspan noted to Congress the disparity between the overall pace of economic growth and the extraordinarily low level of bond yields. From 2002 the pace of US nominal growth accelerated sharply, whilst yields remained broadly unchanged. This reversed the trend in place since 1980, where yields were typically above the rate of growth (See Figure 1). Many have attributed this to the forces of globalisation which have lowered inflation expectations and risk premia. But as Greenspan commented, these forces had been in place for many years. So something else has to explain the current disparity between the level of yields and the growth rate.

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US NOMINAL GDP AND TREASURY YIELDS

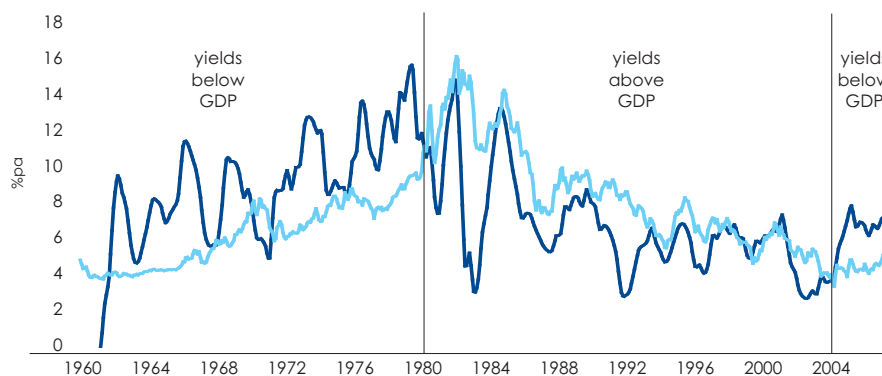


Figure 1

— Nominal GDP growth — Bond yields

Source: EcoWin

Foreign capital flows into US bond markets are a prime contender. These flows are substantial, averaging an annual rate of around 2% of US GDP since 1980 and reaching 8% of GDP in late 2004. The make up of these flows is important too. Foreign official flows, those resulting from central bank activities, are often cited as the dominant source of demand for Treasuries, in particular activity by the Bank of Japan and the People’s Bank of China. More recently Petrodollar flows have overtaken flows from Asia, although these flows are often more tricky to track down and often show up in the ‘private flows’ category (see Figure 2).

One of the most comprehensive studies of the effects of these flows on US bond yields was conducted by Warnock and Warnock of the Federal Reserve¹. Their analysis shows that if there were no foreign purchases of US bonds over the previous 12-months (by foreign central banks or from private capital flows) then 10-year Treasury yields would be 150 basis points higher. The assumption of zero foreign capital flows is of course unrealistic, but even allowing for average annual flows of around 2% of GDP, they found that yields would be 95 basis points higher. They also found evidence to suggest that these capital inflows accounted for around half of the flattening in the US yield curve since 2003.

But globalisation is also a factor. The expansion in global capacity and the associated dis-inflationary forces have lowered the risk premium across asset classes. One measure of the premium provided by bonds is the rolling standard deviation of the monthly change in yields. This has fallen dramatically since 1982 and is currently at its lowest level since 1980. With the flattening of the yield curve, the term premium has all but disappeared. There is, therefore, little premium left in Treasuries to compensate investors for the duration risk, but then, perhaps they don’t need so much compensation. To use the Fed’s term, there has been a great ‘moderation’, both of inflationary expectations and of economic volatility.

CAPITAL INFLOWS TO US TREASURY MARKET

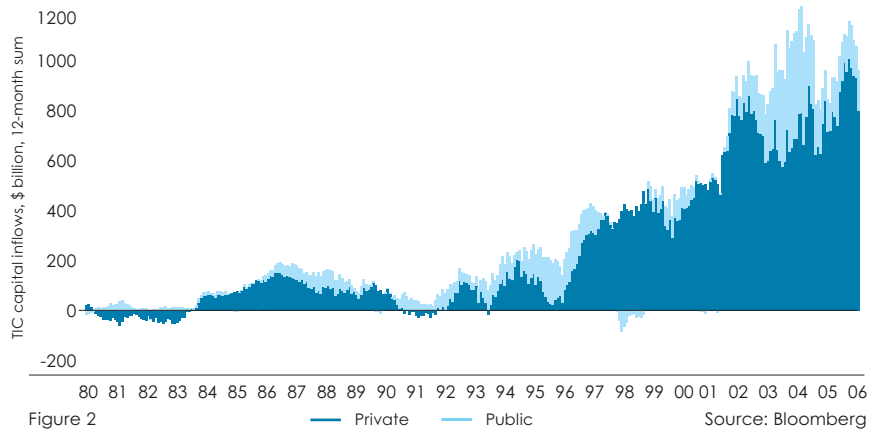


Figure 2

Source: Bloomberg

In part, globalisation is the cause. As developed countries move from manufacturing to services, economic volatility falls, and as developing economies move from agriculture to manufacturing, their economic volatility falls. The low level of bond yields is not just a US story. In the UK, long dated UK index linked bond yields fell to just 0.38% in January 2006.

Yields remain low on a historical basis and particularly when compared to nominal GDP growth. Moreover, real 10-year yields across the developed world are now at their tightest spread in a generation.

The extraordinarily low level of yields has spurred significant changes in institutional investment activity as investors search for higher yielding assets. So who has been buying and selling? Overall, inflows into UK investment institutions have remained very strong, reaching £65 billion in the first

three quarters of 2006, already matching the inflow seen through the whole of 2004; just £10 billion off the record highs of 2000.

While overall demand for savings and investments remains as strong as ever, net investment patterns of these flows have changed significantly, as illustrated in Figure 3. UK institutions have been net sellers of equities for the past six years, driven primarily by life and pension funds. There are good reasons for this. The unfortunate change in the regulations that led to increased Liability Driven Investment (LDI) demand (see ‘Time to change the rules’, Fundamentals, March 2006) is one. The expected increase in run-offs at Life Insurance schemes is another.

UK institutions’ reduction of equity holdings makes recent market performance all the more impressive. In the absence of institutional demand, the double digit

¹Warnock and Warnock (2005) International Capital Flows and US Interest Rates, Board of Governors of the Federal Reserve System, International Finance Discussion Papers, Number 840

UK NET INSTITUTIONAL INVESTMENT

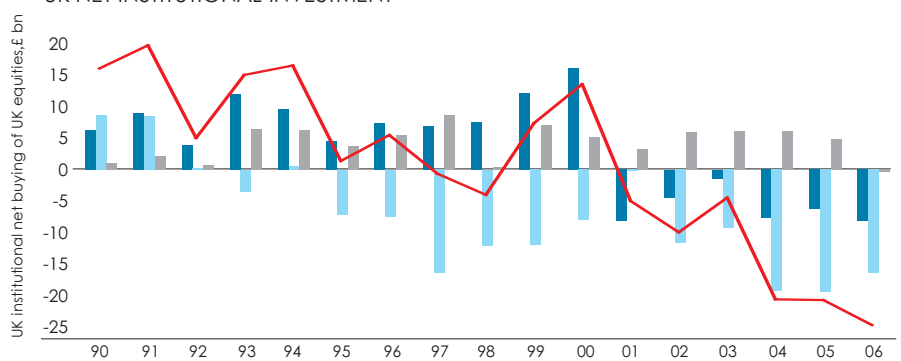


Figure 3

Source: National Statistics

EUROPEAN MUTUAL FUND FLOWS

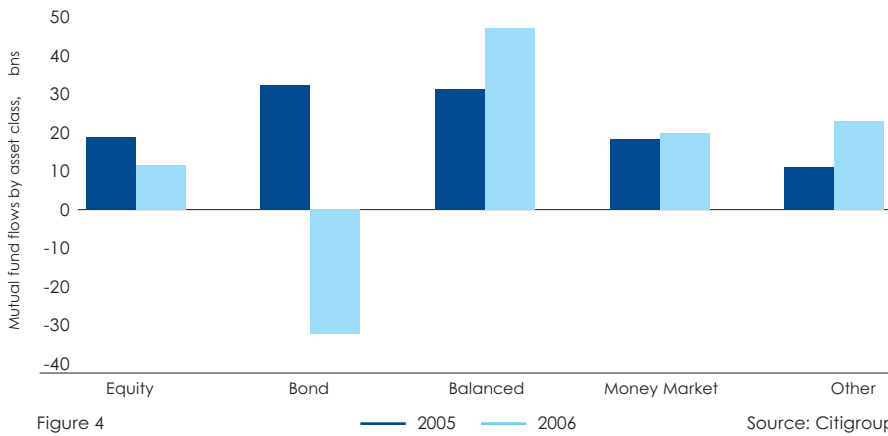


Figure 4

Source: Citigroup

returns since the market low in 2003 have been driven by private equity and corporate and overseas buyers. Indeed, overseas investors currently own the largest share at 37% of the UK equity market, though UK institutions still hold 30%. Household ownership meanwhile has remained broadly unchanged at around 15%.

So if UK institutions have been net sellers since 2001, where are the funds being invested?

Institutions are not nearly as averse to holding overseas equities and have in fact been net buyers since 2001, albeit at a declining rate. The overseas bias is reversed for government bonds – institutions have been net buyers of gilts since 2002, but were net sellers of overseas government bonds between 2001 and 2005. This corroborates the US Treasury International Capital flow data that shows private capital is the main source of demand for US Treasuries.

It is interesting to note that despite four years of double digit returns, private investors remain very risk averse. Figure 4 shows that across Europe (including UK) there has been a significant shift in favour of balanced funds.

But by being averse to risk, investors have lost out on returns. According to IMA data, the best performing funds over 2006 were equity funds, particularly those funds that focus on the smaller, riskier stocks. Bond funds, both UK and

global, were the worst performers. Balanced and income funds have generated positive but unspectacular returns. On a five year view, balanced funds have typically achieved around half of the returns achieved by the range of equity funds.

Unwinding the conundrum

So, to summarise, we can categorise the drivers behind the low bond yields in three broad groups:

- 1) Fundamental improvements – from rising cash yields at corporates, to falling debt ratios in emerging markets.
- 2) Falling risk premiums on debt – caused by well anchored inflation expectations and falling macroeconomic volatility.
- 3) An unusual ‘asset allocation’ favouring debt – caused by cautious government investment of large current account surpluses, LDI at pension funds and a surprisingly cautious UK retail investor.

The \$1,000,000 question is whether the conundrum will unwind?

To answer this we rely on our macro and asset allocation roadmap.

Our roadmap starts with a view on valuation. Here we believe that global equities offer a healthy risk premium, whereas global bonds offer very little. On a regional basis, we see the UK, Europe and the US offering the most attractive equity premiums. Emerging markets offer the least.

In both the US and Europe, the equity earnings yield ratios are at the very bottom of their long term trading range (shown in Figure 5), meaning that there remains a strong valuation case for equities vs bonds. The issue here is clear. As long as earnings hold up, in other words as long as global growth holds up, then equities are cheap against bonds.

The case for equities is even more compelling when we consider the strength of equity cash flows. US flow of funds data shows that the corporate sector has accumulated considerable free cash flow during the recovery. Indeed, free cash flow yields are currently at their highest level for over 40 years.

Again, this is not unique to the US. Free cash flow/sales in Europe are currently around 5%, having risen from zero in 2000 and compared with the long run

US AND EUROPEAN EARNINGS YIELD RATIO

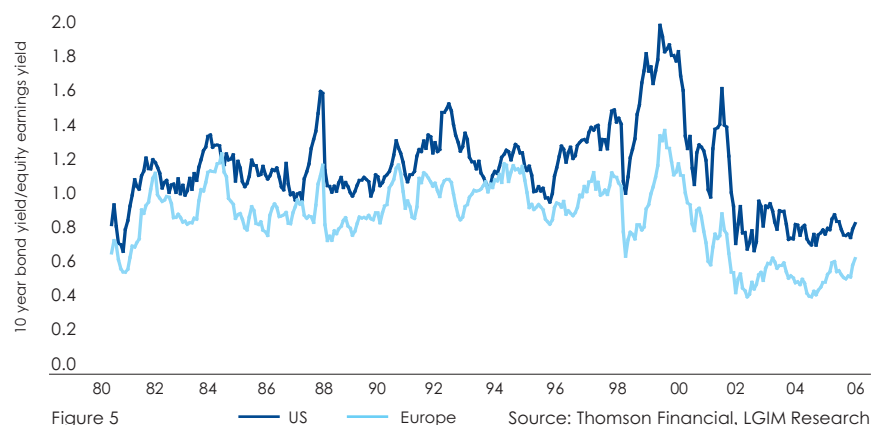


Figure 5

Source: Thomson Financial, LGIM Research

average of around 2%. This leads us to prefer equities to bonds on a structural basis.

So far so good, but should we prefer 'growth', expressed either by buying equity vs credit/bonds or even as a style within equities.

To answer that we need to look at the macro. Right now, US resource utilisation is high and stable. So what does that mean for yield compression? Historically, the sweet spot for yield compression is a world of low resource utilisation, low rates and accelerating growth. In a world of high resource utilisation, higher rates and a steadier expansion, then betting on yield compression is rarely the best investment strategy. Growth almost always wins out.

This is because higher resource utilisation tends to go hand in hand with higher rates and the higher the rates, the less attractive is a dividend. Investors need the prospect of robust capital growth to compensate for the loss of the income that would be received if the money was kept in a bank.

So, if we think that growth and equities are more attractive style and investment instruments than yield compression and debt, how will that manifest itself? Who are the buyers and sellers?

In part, this will happen as petro-states raise their imports, see their surplus erode and then funnel less cash into global debt markets. Likewise, several emerging markets are likely to see an emergent credit culture which should raise consumption, diminish the size of surpluses and raise the risk premium on bonds. An asset allocation switch from bonds to higher risk instruments in China and the Middle East is a growing likelihood. Overall, though this will likely take several years, not several months, to work through.

Whilst there are good reasons to expect continued strong LDI flows, there are several groups of investors that can help close the gap between corporate free cashflow yields and corporate debt yields in a more speedy manner.

PRIVATE EQUITY: Strong cashflow and cheap debt is an ideal backdrop for private equity. We expect further strong buyout activity this year, with some estimates of private equity firepower as high as \$1 trillion. But the private equity bid will not be complete plain sailing. EV/EBITDA, a key ratio for buyout firms, has risen quite sharply for the small and medium sized companies that are the bread and butter of the Leverage Buyout Operators (LBO). This means that buyout firms are having to work harder to add value. This is why there is an increasing desire for a property or turnaround angle for many private equity deals.

CORPORATE ACTION: We see some of the best arbitrage opportunities between debt and equity in the large and megacap space. Clearly, the largest companies are out of reach of private equity, although we expect to see private equity syndicates take on bigger and bigger targets this year. The companies could help themselves. They could issue debt to buy back shares and they can undertake M&A to unlock value out of the reach of private equity.

When we combine buyouts, buybacks, dividends and M&A (that is not funded by equity issuance), we can see that it is a very powerful force. In the US last year, the combined total reimbursement to equity investors was a massive 9% of equity market capitalisation, a 17-year high. We see little reason for this process to unwind.

HEDGE FUNDS AND PRIVATE INVESTORS: If there is an attractive arbitrage, you can guarantee that hedge funds will exploit it. We also expect that equity market momentum will, in due course, bring the retail investor back into the market.

So we have identified the value, we have identified the cyclical dynamics and we have identified the potential buyers. What could go wrong in our call? Inflation.

If you remember the 60s you weren't there. I don't know who said that, Abbie Hoffman perhaps? But for financial markets the quote might be turned around a little; 'If you remember the 1960s, you're not here'.

There are few in markets now who were active in the 1960s. This is a shame, because there is more than a passing similarity between the current situation and the early to mid-1960s. Back then, yields tended to run below GDP. Resource utilisation and wage growth were strong. It took until the mid 1960s though, for bond yields to react to the latent inflationary pressure. Right now we also have a hiatus in bond yields for the many and varied reasons described above.

But sustained high resource utilisation will tend to raise inflationary pressure. This would tend to reduce the attractiveness of income vs growth. The key question is how fast will this inflationary pressure build?

That is perhaps the toughest question in macro. In our view, strong wages, a recovery in industrial production and in housing will raise the inflationary heat. Bear in mind that there are drags on inflation, the lagged effect of 11 months of sub-trend growth in the US and the downward pressure on rents from the excess stock of houses in the US. It is unlikely that inflation can rise fast enough to force the Fed to hike this year. If bond yields rise enough as the recovery builds and if oil prices break up towards \$65/bbl, maybe we'll even have another temporary slowdown later this year.

Overall, we think the economy will get hot enough for the market to change its tune from yield compression-a-go-go to growth-a-go-go, but not so hot as to force the Fed to turn off the jukebox.

Market Overview

A correction, not a bear market

The 9% drop in the Chinese equity market on 27 February 2007, the largest single day drop in ten years, sparked a significant global market sell off. The S&P 500 slid nearly 5% to 1380, the DJ Eurostoxx 600 fell over 7.5% and the FTSE 100 dipped below 6000 for 15 minutes during trading on 5 March 2007. Unsurprisingly, market volatility spiked aggressively, rising to the highest since the sell off in May/June 2006.

The fall in global markets was not a direct result of the fall in China. A wide range of reasons have been suggested, including a weak US durable goods report and rising defaults in the sub-prime mortgage market, fuelling wider concerns about the US growth outlook and Alan Greenspan's use of the 'R' word.

The real issue is, how far will this run. At the time of writing (12 March), markets have already stabilised to varying degrees. The Chinese market staged a bounce after the one day of weakness, a bounce that many markets appeared to ignore as they continued to slide. The S&P 500 is currently around 1.8% off the low point on 2 March 2007, while the FTSE 100 is 2.6% higher.

We believe this move will not be as long lived as the correction in May/June of last year, primarily due to US monetary conditions. Bond yields have been falling since late January, unlike last year when yields rose by around 90bp prior to the correction. Energy prices are similarly more supportive in the current correction. In the six months to 27 February 2007 energy prices fell by around 13%, compared with a rise of around 17% in the 6 months prior to 9 May 2006.

These factors taken together are positive for growth as they provide a significant stimulus to consumption, which in turn is a positive signal for world equity market performance. We therefore remain positive on the outlook for equities.

London

Markets continue to look for another rate hike

The Bank of England has held rates steady since the surprise January hike, reflecting the somewhat more mixed economic landscape over the month. The PMI surveys continue to point to robust growth, while according to the CBI, industrial orders are at their highest level since 1995. Confidence within the corporate sector has prompted a revival in business investment. Despite this strength, the MPC have paused to watch the impact of last year's rate hikes. There are early signs that housing activity is responding, with mortgage approvals down sharply in December. However, house price inflation is still running in double figures and the RICS survey suggests upward pressure on prices remains strong. Going forward the Bank of England will be looking for a pick up in retail sales, which dropped sharply in January. Money markets currently expect the Bank of England to hike rates again in the second quarter.

The UK equity market continued its upward progress for most of February only for these gains to be wiped out in the last few days of the month on the back of the correction in global equity markets. The market posted a negative total return of -0.2% in February with only small caps producing a positive return (+0.6%). There were few significant sectoral trends although Autos, Food Retail and Construction performed well supported by bid speculation. The corporate results season has been generally positive with a number of companies using their balance sheet and cash flow strength to significantly increase dividend payments. The most notable corporate event in the month was the private equity approach for Sainsbury's. Elsewhere MyTravel

announced plans to merge with rival, Thomas Cook, a move that was very well received by the market. We believe the fundamentals for the UK stockmarket remain sound, valuations continue to appeal and further corporate activity is in prospect.

Wall Street

Federal Reserve maintain a tightening bias

The recent run of US economic data has continued to be mixed. The Manufacturing ISM bounced back above the 50 no-change level in February, but the Non-Manufacturing ISM survey dropped sharply. After showing signs of stabilization at the end of 2006, data from the housing market has been somewhat softer, with concerns focused primarily on the sub-prime mortgage market. Despite the mixed backdrop, consumers continue to hold up, reflecting the still supportive labour market. The Federal Reserve maintain their tightening bias, as they expect the current drag on growth from weak inventories and the housing market to be short lived and look for growth to recover after the first quarter. Despite this bias, money markets continue to price in a rate cut by the end of the year.

The S&P 500's eight month run of positive monthly returns came to an end as the index declined 2.2% during February. Softer economic data, higher oil prices, a stable to negative monetary backdrop and rising sub-prime mortgage delinquencies were some of the concerns cited by investors. S&P earnings grew just over 10% in the fourth quarter of 2006. However, first quarter earnings estimates have continued to decline, analysts now expect 5% year on year earnings growth in Q1. The outlook for the equity market remains constructive for 2007 despite the near-term increase in volatility. Whilst the profits cycle is clearly

slowing, valuations are very supportive for equities, against bonds, real estate and credit. Corporate balance sheets remain very strong, with free cash flow at levels that will likely support the equity market in any period of market consolidation. In the near term, investors will look for further signs of weakness in economic data to confirm a bearish bias.

Europe

Strong momentum heading into 2007

The European economy has held up well so far this year, despite signs that confidence is coming off the top. Regional business surveys remain at elevated levels and the EC survey of consumer confidence continues to trend higher. Across the region, fourth quarter GDP figures showed notable improvement, giving the region considerable momentum heading into 2007. In France, consumer spending data has picked up, although in Germany, sales fell sharply in January in response to the VAT increase. As yet, the inflationary implications of the hike appear benign and this will be an important factor in assessing how consumer behaviour will respond going forward. With the ECB set to continue raising rates, consumer confidence could begin to wane, but conditions look sound for now. Money markets are currently pricing in at least two more rate hikes this year.

European equity markets were not immune from the global slide at the end of February. Austria was the worst affected European index, falling by 4.1%, compared with declines of 1.6% and 1.1% in France and Germany. Across Europe, the best performing sectors over the month were Steel, Food Retail and Autos, with the bid for Sainsbury's a key factor. Prior to the fall in the last few days of the month, markets had continued to tick up the trend line that began last Autumn. The region still offers attractive valuations and with the economic data holding up, the near term market outlook is robust. Going forward, the strength of the Euro will continue to weigh on sentiment among the exporters, as will the impact of the German VAT hike, should this begin to impact intra-regional trade.

Japan

BOJ finally tightens rates

The Bank of Japan finally raised interest rates, taking the overnight call rate to 0.5%, encouraged by stronger and more balanced fourth quarter GDP growth. However, the much awaited stronger domestic consumption and retail recovery has not materialized. Company profits remain very strong with an improved employment market, but this has been mainly focused on the large cap exporting companies. These firms have given better pay rises and bonus payments, but they only account for 18% of total employment in Japan, with the remainder in domestic small and medium sized companies and public corporations that are not seeing the same profit growth and wage gains. However, we remain positive on the outlook for the Japanese economy.

The market has now entered a correction phase after a steady move higher from the July 2006 lows. The recent strength in the yen after long term weakness could switch focus in the market away from exporters and defensive high yield stocks back to the lagging areas of domestic demand such as banks, retail service sectors and small / mid caps that have underperformed for many months. A strong theme for 2007 we believe is the Merger & Acquisition activity that has picked up in all sectors led by foreign investor intervention into the Japanese asset, land and cash rich companies. This is a positive trend for the market and we feel that the retail sector and REITS are the next area of focus for M&A activity and value extraction. Overall, we believe there is further upside potential for Japanese equities.

Pacific Basin

Chinese fundamentals remain positive

In February the FTSE AW Asia Pacific ended the month up 0.5% in sterling terms.

FTSE Thailand was the best performer up 6.0% boosted by the Thai baht up 2.6% in sterling terms. Thai interest rates were cut by 0.25% to 4.5% and the central bank moved to ease the remaining capital controls for foreign inflows into bond and property funds. South Korea also rose materially, up 4.3% on foreign net buying.

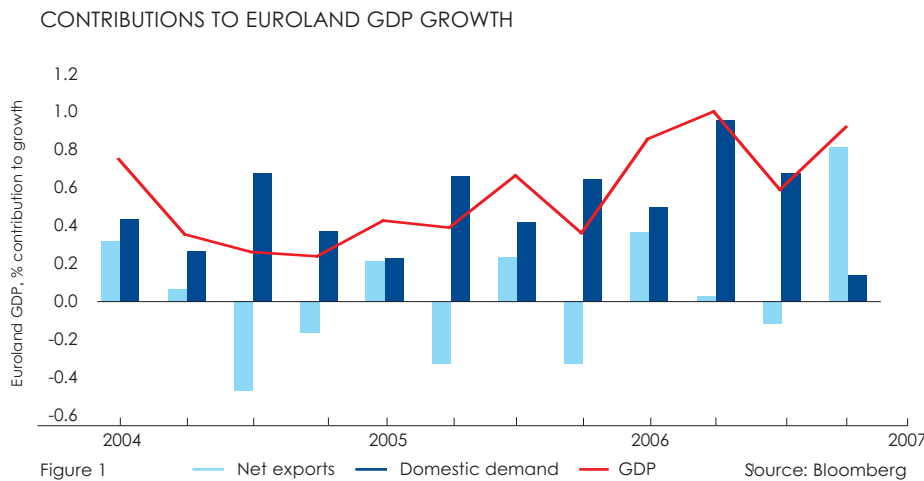
FTSE India was the worst performer down 7.9% as the country's inflation increased and hopes for reforms were absent in the budget. The Philippines fell 7.6% on profit taking after its recent strong run. FTSE China was weak at month end, it finished down 1.6%. This was a reaction to the correction in domestic A-shares, precipitated amongst other things by investors' fears of more government measures to cool the stock market. The State Council announced a co-ordination body to monitor, control and regulate illegal securities market activities.

In China investors will closely watch developments at the National Peoples Congress (NPC) held in early March because policy tightening has always been carried out in late March/April. Despite the ongoing correction we remain optimistic on the fundamentals of the Chinese economy. We do not believe the government wants to crush the stock market and will tread carefully to control the pace of asset appreciation and reduce speculation. Moreover stability and social justice will be a theme at the NPC; a healthy capital market is important for Beijing to sell state assets and pursue pension reform to help build Chinese society.

Snapshot

European GDP growth

The Euroland economy staged a healthy pick up in momentum at the end of 2006. GDP growth picked up to 0.9% in the fourth quarter, shown by the red line in Figure 1. The chart also shows the relative contribution to that growth from domestic and external demand. The sharp rise in the light blue bars highlights the very strong contribution from net exports over the quarter, accounting for almost all the growth. Domestic demand meanwhile has been making a declining contribution to growth.



The strength of net exports was driven largely by Germany, whose exports accounted for 33% of total Euroland exports over the fourth quarter. As the table below shows, global demand for German goods rose by 6% over those three months, the strongest rise since late 2000. The weakness in German household consumption is also noteworthy, given the expectation that consumers would bring forward their spending ahead of the VAT hike in January. The table shows there is little evidence to support this notion with spending rising by just 0.3%, down from 0.8% in Q3.

EUROPEAN Q4 GDP GROWTH BY COUNTRY % QUARTER ON QUARTER

	GDP	Private Consumption	Government Spending	Fixed Investment	Exports	Imports
Eurozone	0.9	0.6	0.5	1.2	3.7	1.9
Germany	0.9	0.3	-0.1	1.0	6.0	1.6
France	0.6	0.4	0.6	1.1	1.2	0.3
Spain	1.1	0.2	0.0	1.8	4.5	2.0
Italy	1.2	1.3	2.3	2.0	2.5	3.6
UK	0.8	1.0	0.4	2.5	-1.0	-0.2

Figure 2

These figures suggest that, while headline growth numbers look strong, the underlying support for growth going forward is somewhat disappointing. If global demand for European exports wanes over 2007, the region would need to see a significant improvement in consumption to maintain the current rate of growth. According to the EC survey, consumer confidence has indeed been improving, as has employment. But wage growth remains benign and further interest rate hikes are likely to squeeze incomes.

The housing market is also a key factor. Mortgage lending has been rising since 2002, but in recent months has begun to wane. Just as a rising housing market has boosted the economy in recent years, a slowdown is likely to unwind that effect. Overall, while the Euroland economy is holding up well at the moment, there are some clear risks to growth for the remainder of this year.

Views Commentary

Inflation expectations scaled down

	Price Inflation (RPIX)		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 2007
ABN Amro	3.00	2.90	2.80	2.80	6.50	7.00	5.10	-	5.75	6.00	2.05	2.04	0.66	0.68	7000
Citigroup Smith Barney	-	-	3.10	2.90	5.80	6.00	4.95	4.95	5.40	5.75	1.93	1.93	0.66	0.64	6800
CSFB	1.60	2.30	2.70	2.80	6.20	6.60	4.70	-	5.50	5.50	1.89	-	0.68	-	6500
Deutsche Bank	2.20	2.00	2.70	2.10	7.50	6.70	4.80	-	5.60	-	1.85	-	0.73	-	6700
Goldman Sachs	2.40	2.90	2.70	2.90	6.69	6.71	4.80	5.00	5.25	5.25	1.94	1.94	0.69	0.71	-
HSBC Securities	2.00	2.50	1.80	2.20	5.00	5.00	4.30	4.60	5.00	4.75	1.93	1.83	0.72	0.74	6850
JPMorgan	2.10	-	3.00	2.80	-	-	-	-	5.50	-	-	-	-	-	-
L&G Investment Management	2.00	2.30	2.90	2.60	8.00	8.00	4.85	4.85	5.50	5.50	1.90	1.85	0.69	0.69	6450-6550*
Merrill Lynch	2.70	2.50	2.80	2.30	6.00	6.00	4.70	-	5.50	5.00	1.87	1.73	0.71	0.74	6450
Morgan Stanley	2.60	2.50	2.40	2.30	6.00	6.00	5.30	5.30	5.25	5.25	1.85	1.73	0.67	0.67	6550
UBS	2.30	2.90	2.80	2.70	5.60	9.40	5.00	5.15	5.25	5.25	1.91	1.90	0.70	0.70	6550
Median (ex L&G Inv Mgt)	2.30	2.50	2.75	2.75	6.00	6.60	4.80	5.00	5.45	5.25	1.91	1.90	0.69	0.70	6625
Last Month	2.60	2.57	2.70	2.65	6.40	6.20	4.80	4.95	5.50	5.25	1.92	1.93	0.68	0.69	6600
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 2007, not a point forecast.

Respondents to our survey this month continue to show confidence in the UK economy over the coming two years. Expectations for growth have been revised slightly higher from last month, with 2.75% penciled in for both 2007 and 2008. Despite this solid growth outlook, inflation expectations have been revised down, reflecting the impact of lower energy costs. RPIX inflation is now expected to fall to 2.3% by the end of the year, rising to 2.5% by the end of 2008. Interest rate expectations are basically unchanged from last month, with one more hike due this year.

In the currency markets, sterling is forecast to fall slightly from current levels against both the dollar and the euro. Gilt yields are expected to remain around current levels, ending the year at 4.8% before rising to 5.0% next year. In the equity market, the FTSE 100 is expected to be at 6625 at the end of the year, slightly higher than last month's survey, while the Bull-Bear gap has narrowed to 550 index points.

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