

## Navigating unpredictable markets

Equity markets rallied significantly in 2009 as the economic recovery in the developed world got underway and the financial system found its footing. The prospect for further strength, however, hinges on the uncertainty which continues to weigh on equity markets. High government debt levels, weak consumer spending, companies' ability to access credit, headline grabbing news and erratic economic data are all likely to unsteady the market at various points this year. Despite this uncertainty, however, we believe equities can make modest progress during 2010, with the most significant investment opportunities to be gained at the sector and stock level. In this edition of Fundamentals, LGIM's equity strategist Georgina Taylor explains what these opportunities are and how investors may benefit from them.

### Range bound

Post the trough in equity markets in March 2009, investors were able to enjoy strong returns simply from having equity market exposure as the economic recovery appeared to be underway. 2010 is likely to be different. This year, we believe investors will continue to be surprised by just how long it takes for the world to emerge from the recent economic downturn and

financial market chaos. With economic data and news flow likely to send mixed signals over the coming months, we expect the investment environment to remain challenging.

A more difficult backdrop this year suggests investors will need to delve further into the detail of what moves equity markets. Indeed, significant

opportunities may continue to exist despite the seeming lack of direction for equities as an asset class.

In order to understand what drives the share price performance of UK listed companies, it is vital to differentiate between domestic and global factors. This is because, on the whole, UK companies generate the majority of their sales outside



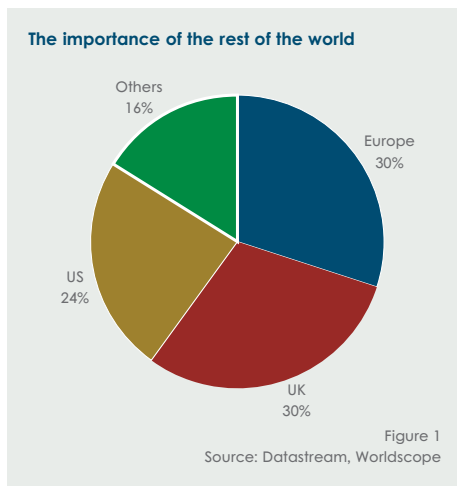
### Inside:

Market Overview

Snapshot: Global business confidence is peaking

Forecasts: Growth revised lower

## Article Contd.



of the UK. Therefore, investors will need to balance the often conflicting influences of domestic and global macroeconomic drivers. For example, while the recent fall in sterling will have helped sales revenue, domestic financing costs have been rising (discouraging both consumers and companies from borrowing) which will ultimately hurt company profitability.

In our view, equity markets will remain 'range-bound' over the coming months, only heading marginally higher into the year-end, as valuation remains supportive and economic growth steadily improves. For that reason, we believe the greatest equity market opportunities will be found at a sector and stock level. 2009 was about the asset allocation decision (i.e. having exposure to equities). 2010 will be more about sector and stock views. We discuss these opportunities in the coming pages.

### The market is not the economy

The UK economy is quite out of favour at the moment. As a result we've seen a sharp fall in sterling and a rise in gilt yields. This is understandable given the ongoing concerns regarding the extent of UK public sector debt. However, investors need to marry the outlook for the domestic economy with the equity market outlook. We must remind ourselves that the UK equity market is not necessarily directly reflective of the UK economy. As a few basic statistics show, UK equities are much more geared into

global dynamics rather than purely what is happening in the UK. For example, official UK economic growth figures show consumption accounting for approximately 65% of GDP and manufacturing accounting for 15%. A breakdown of the UK equity market, on the other hand, reveals a very wide definition of consumer sectors, to include utilities and healthcare, account for 38% of the total market capitalisation of the FTSE 350 index. Manufacturing sectors account for approximately 8% and commodities also play a critical role for the UK market, with the oil and basic resources sectors accounting for around 30% of the market.

A large part of the listed UK market has significant overseas exposure. Roughly 70% of UK company sales come from outside of the UK (Figure 1). That makes global growth dynamics and currency fluctuations significant forces behind opportunities at a stock level.

### Eastern influence

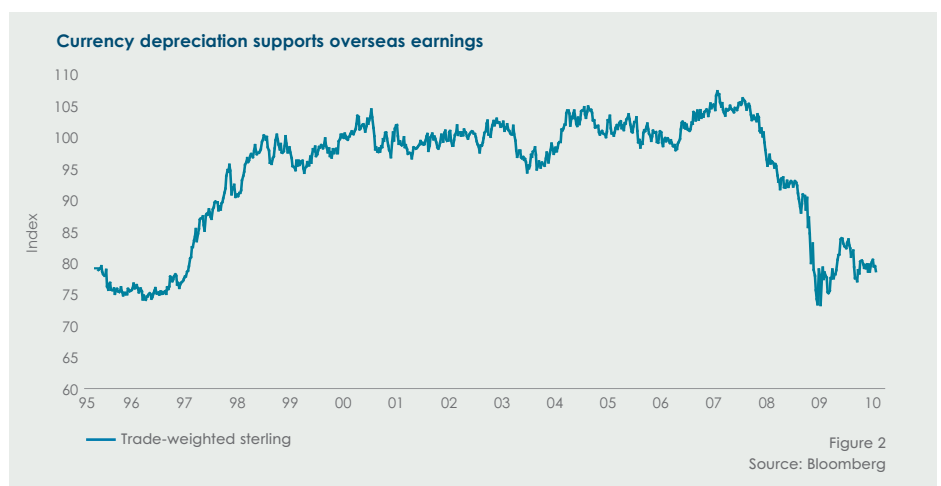
One of the greatest opportunities for investors, in our view, is from emerging market revenue exposure. We maintain our view that emerging markets will deliver superior growth versus developed economies. Importantly, however, the way to extract the best returns from this dynamic has changed from a year ago. During the past twelve months mining companies in the UK have outperformed

the broader market index by c. 70%. Investing in this sector of the market (either in UK or European listed equity markets) has been a relatively easy way for investors to implement their view on strengthening emerging market demand.

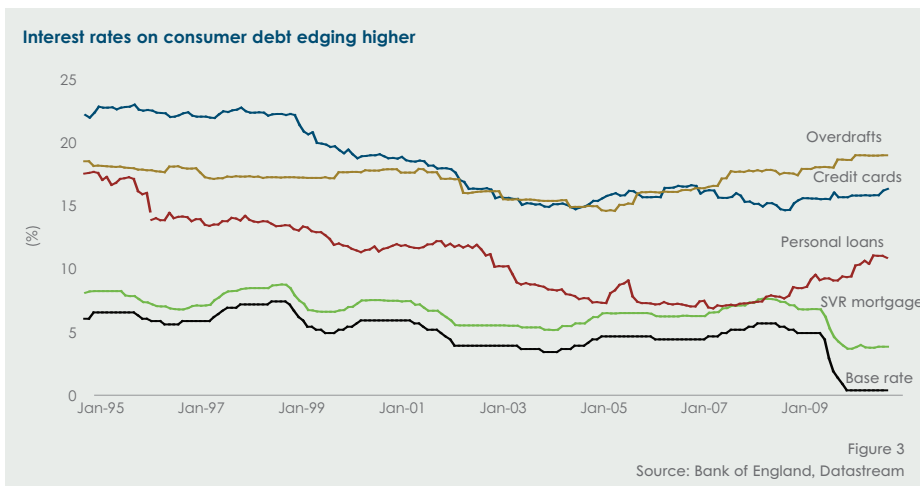
Moving forward, however, we believe the mining sectors in the UK and Europe could come under pressure as budgets for infrastructure projects may come under fire as Governments in the region try to reduce their deficits. Therefore, focusing on consumer trends and where companies are likely to be increasing capital expenditure across the region could provide for a better investment opportunity.

One way of looking at this opportunity is to distinguish between large and smaller companies. 70% of the sales made by the largest 100 UK listed companies (large cap) are outside the UK. In contrast mid-cap stocks receive less than 50% of their revenues outside the UK.

Sterling has fallen by 25% since mid-2007 (Figure 2), again providing support for companies with overseas exposure. There isn't a simple one-for-one relationship though, as many companies also have much of their costs based offshore as well, meaning the impact on their earnings is generally less than the sales data would suggest. However, in an environment where muted economic



## Article Contd.



growth in the developed world is weighing significantly on company profitability, the fall in sterling is certainly a welcome and important buffer for UK companies with a global footprint.

### The cost of debt

Despite a large proportion of the UK equity market having sales exposure overseas, borrowing costs tend to be more influenced by domestic factors which impact both the consumer and corporate sectors. On the positive side, in the UK, mortgage rates are generally tied to official interest rates set by the Bank of England (BoE). This is in contrast to the US where mortgages are tied to bond yields and therefore influenced by market participants, which in turn makes it far harder for policy makers to control them.

However, although mortgage rates are tied to official interest rates (the “base rate”) set by the BoE, the financial turmoil of the past couple of years has caused the difference (or spread) between the base rate and mortgage rates to rise. As the financial system continues to be rebuilt, we believe the BoE will leave official interest rates at extreme lows for some time, allowing banks to continue to re-build balance sheets and improve profitability.

On the flipside, the UK consumer has had a one-off boost to income from a reduction in mortgage payments, which has in turn boosted the savings rate in

the UK. However, at some stage, interest rates will need to rise. Given the spread on mortgage products is far higher than it has been in recent history (and is likely to remain high for some time) mortgage payments are likely to start to rise. This will act as a continual drag on consumer spending. Indeed, if we look across other aspects of consumer financing costs, we are already witnessing rising interest rates on overdrafts, credit cards and personal loans (Figure 3).

### The cost of equity

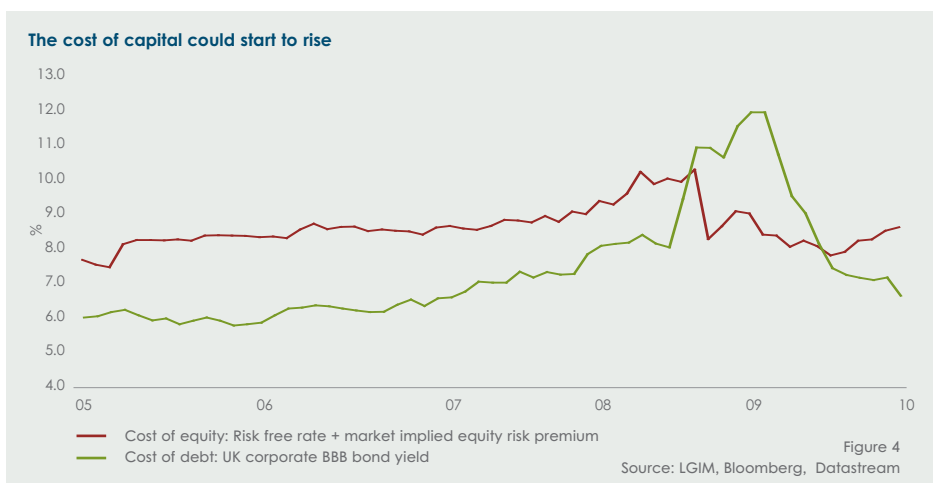
It is getting increasingly complicated to determine the ‘fair value’ of equities. In general, analysts value all asset classes by using some sort of base – which tends to be the domestic 10-year bond yield. Investors look at the dividend yield on equities versus the respective 10-year bond yield and also calculate a ‘risk premium’ using this bond yield.

Calculations of projected future earnings for a company also use the same yield assumption. Therefore, the rise we’ve seen in bond yields has significant implications for valuing equities. Aspects such as the outlook for economic growth, potential inflationary pressures and supply and demand for government bonds (made complicated due to recent quantitative easing activity) may all impact equity market valuations over the next two or three years.

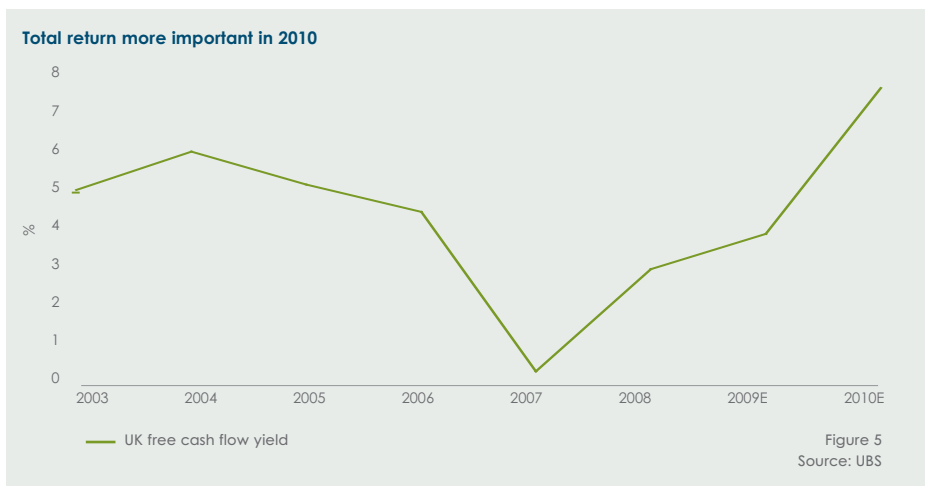
In addition, investors need to consider two other factors. Firstly, uncertainty surrounding sovereign risk has meant the government bond yield, commonly referred to as the ‘risk free rate’ may now actually require a risk premium. Secondly, with financial markets increasingly global, even if policy rates do not rise domestically, higher policy rates elsewhere (such as in China) will influence the flow of capital and in turn could put upward pressure on UK government bond yields.

The bottom line for corporations is that the cost of equity is likely to rise (Figure 4). This is due to both bond yields rising and also as a result of the higher risk premium given the uncertain corporate outlook.

The cost of debt is directly linked to credit markets. In last month’s edition of Fundamentals, LGIM’s credit strategist,



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Ben Bennett, discussed how lower credit spreads have increased the interest rate risk embedded within credit markets, and as such credit markets are more vulnerable to sovereign risk and rising government bond yields. However while much has been said about the ‘crowding out’ issue where an increase in the supply of government debt will absorb capital, leaving very little left over for the private sector, we believe it is too early for this concern, which is not likely to be an issue until 2011 and beyond.

In the near-term, we believe the risks surrounding Government bonds will act as a drag on overall market direction as the yield advantage of equities becomes eroded at a time when the growth outlook for profits is still unclear. In this environment investors should be firmly focused on companies with strong balance sheets that are able to generate cash and finance themselves without relying solely on capital markets to raise finance.

### Cashback or capex?

We believe dividends are likely to make up a higher proportion of total equity returns for investors than they did last year. Further, we believe the best investments are in companies which have high free cash flows (Figure 5), so they are able to pay dividends as well as respond to investment opportunities without having to rely on capital markets. We also believe companies will start to

gradually increase capital expenditure this year, financed through this cash flow. However this rise will not be driven by domestic expenditure in developed markets (where growth will be slow), rather it will be led by investment in the emerging market region.

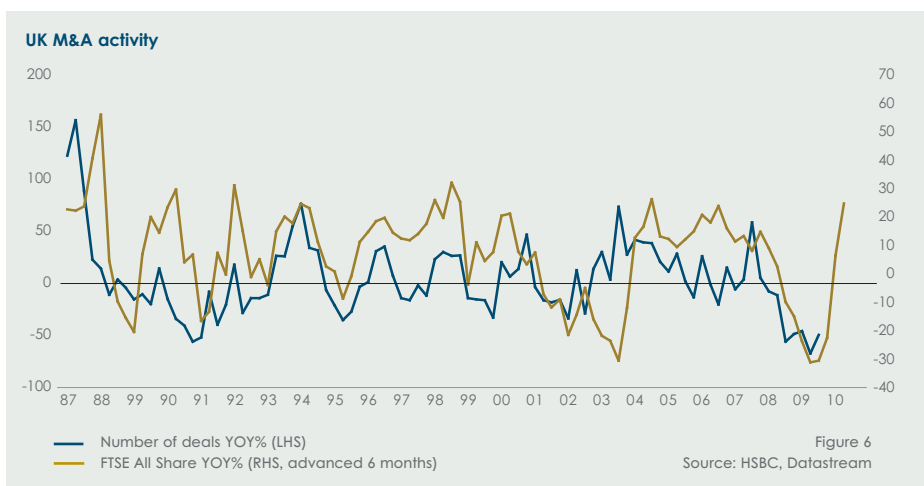
Another side to the cash investment theme is the potential for Merger & Acquisition (M&A) activity. We think M&A activity will start to pick up slowly during the year across industries. For companies with strong balance sheets looking to acquire growth in the current environment, this provides a good opportunity. There is a fairly good relationship between M&A and equity market performance with a lag of around six months, therefore the strong performance in equities during 2009 suggests we should see a rise in M&A activity this year (Figure 6). From a UK

perspective, the fall in sterling has increased the relative attractiveness of UK assets for overseas buyers.

### A closer look

Finding the best return opportunities in equity markets is a moving target. As macroeconomic and financial developments continue to shape the investment environment, different opportunities and risks are likely to emerge. Currently, we view the largest risk to the market as a whole in 2010 relates to the time it will take to recover from the financial crisis of the past couple of years. In particular, this relates to the rise in government debt and the impact on raising capital across the private sector.

However, we believe there remain some key investment opportunities despite the lack of market direction. Firstly, we believe focusing on cash generative companies will offer investors an attractive total return, and these businesses will be best placed to expand operations without having to rely on external financing which could be difficult to come by. Secondly, while smaller sized companies have led the most recent rally, it is the larger companies we believe are most attractive in 2010. These businesses typically have far more diversified revenue streams and are able to take advantage of the new mix of global growth and the recent fall in sterling.



# Market Overview

Financial markets began February on an unsteady footing following the ongoing concerns surrounding Greece's national debt. Later in the month, however, equity markets found support from hopes that a sustainable global economic recovery will help drive corporate earnings growth. Broadly positive economic data from the US, Japan and some parts of Europe provided succour for bullish investors as central banks moved down the path of phasing out policy stimulus measures. However, doubts remain over the sustainability of the recovery in the post-stimulus environment, particularly as many countries are looking for external rather than domestic demand to sustain their recoveries.

## Equity Overview

### UK

#### Sluggish recovery from a deep slump

Revised data showed that the economy grew by 0.3% during the December quarter, beating the original estimate of 0.1%. However, the sense of relief was soon tempered by the realisation that the earlier slump had been even deeper than earlier data had suggested, with GDP shrinking by 6.25% during the six-quarter contraction, rather than the 6.0% previously reported.

Other UK economic data was almost universally gloomy. Retail sales data recorded their biggest monthly drop in 18 months, partly attributable to the snow. Meanwhile consumer price inflation topped forecasts, rising to 3.5% in January from 2.9% in December, to reach its highest level in over a year. Data also showed that the public finances remain in dire straits, with the government borrowing another £4.3bn in January – normally a healthy month for tax receipts. Narrowing opinion polls ahead of the looming general election did little to help sentiment. Even labour market data – a rare bright spot over recent months – was a disappointment, as a surprise rise in January's claimant count wiped out the modest declines at the tail end of 2009. The Bank of England left the door open to the possibility of further quantitative easing to breathe new life into the anaemic recovery.

The FTSE All-Share index rose by 2.9%, buoyed by better-than-expected results in the banking sector. The aerospace &

### EQUITY OVERVIEW

as at 28 February 2010

Market return (denominated in £)	February (monthly) return %	Rolling 12 month % return
UK	2.9	41.8
US	8.5	42.2
Europe	2.6	44.4
Japan	6.5	22.8
Asia	6.2	72.8

Source: Datastream, FTSE indices shown

Major Equity Markets – Total Returns £ 2009/2010

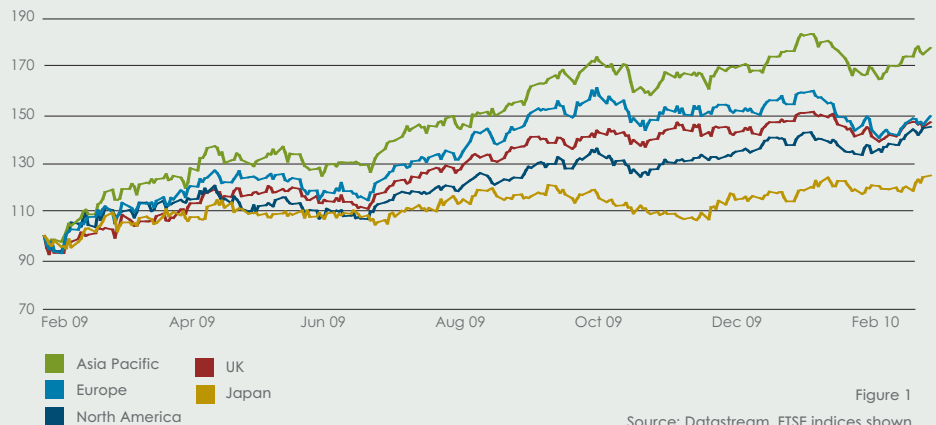


Figure 1  
Source: Datastream, FTSE indices shown

defence sector also performed well, cheered by news that a series of recent new contract wins has helped Rolls-Royce build a record year-end order book.

### US

#### Winding down the stimulus

February brought yet more signs that the world's biggest economy is continuing its recovery, so much so that the Federal Reserve (Fed) outlined further steps along the path of withdrawing some elements of its stimulus package.

The pace of the recovery at the end of last year was revised upwards to 5.9% from 5.7%, though some of this was attributed to inventory effects.

Meanwhile durable goods data was also ahead of forecasts at 3.0%. As consumer spending accounts for more than two thirds of overall US economic activity, news that January's retail sales grew ahead of expectations provided further grounds for optimism. With industrial production figures also broadly positive, the jobs report disappointed with payrolls falling by 20,000 (the market expected a rise of 15,000). Consumer confidence also took an unexpected dip while new homes sales unexpectedly plunged.

A 0.25% increase in the discount rate prompted speculation that a rise in the key Fed funds rate may also soon be

on the cards, particularly given the more hawkish noises emanating from some regional Fed officials. However, Fed chief Ben Bernanke suggested that the steady-as-she-goes policy is likely to be retained for 'an extended period'.

Though US equities slipped in dollar terms, the FTSE All-World North America index rose by 8.5% for UK-based investors during February, thanks to sterling's ongoing weakness.

### EUROPE

#### A recovery of two halves

The latest round of economic figures continued to demonstrate a broad 'North/South divide', with numbers from Germany and France remaining positive in the main, while southern states continued to struggle. The Greek debt crisis remained uppermost in investors' minds despite the prospect of some kind of politically-inspired bailout. However, with the European Central Bank talking tough as President Jean-Claude Trichet repeated his pledge that the Bank will not step in, investors remained uneasy over the lack of detail surrounding the mooted support package from the European Union.

German unemployment numbers showed a smaller-than-expected rise in January's jobless count, confounding expectations that the harsh winter

## Equity Overview Contd.

would give the jobs market a chill. Though the IFO business climate index dipped slightly, the expectations component provided grounds for reassurance that German companies retain confidence in the sustainability of the upturn. Meanwhile the French economy grew by a surprisingly perky 0.6% in the December quarter. However, with the North/South eurozone economic fault line apparently widening, doubts over the sustainability of the 16-nation eurozone bloc's collective recovery were heightened by news that Italy's economy contracted by 0.2% in the final quarter of last year. Spain remained the last major economy still mired in recession, while unemployment hovered around 19%. Eurozone inflation rose by just 0.9% in February compared to a year earlier.

European equities, as represented by the FTSE AW – Developed Europe (ex UK) Price Index, rose by 2.6% in sterling terms over the month.

### ▶ JAPAN

#### Recovery continues but deflation dangers persist

Japan's economy is clearly on the mend, though the Bank of Japan continued to observe that the recovery remains dependant on stimulus.

Retail sales rose for the first time in 17 months in January, while the 11th consecutive gain in industrial output reflected buoyant demand from China, principally vehicles and construction equipment. A leap in export data and rising core machinery orders provided further confirmation that demand at home and abroad is continuing its recovery. Meanwhile Gross Domestic Product numbers confirmed that the economy's robust 4.6% fourth quarter expansion (compared to a year earlier) was achieved through a balance of domestic and overseas demand. However, the Bank of Japan repeated its long-held view that inflation remains a "critical challenge", suggesting that the central bank intends to do all it can to provide ongoing support to the recovery, despite the country's dire public finances. Convincing Japan's traditionally-cautious consumers of the authorities' determination to combat deflation and keep the economic recovery on track are likely to remain vital in helping to sustain the recent upturn in domestic spending.

As measured by the FTSE AW – Japan index, Japanese equities rose by 6.5% during February in sterling terms, with this gain largely attributable to the yen's strength against struggling sterling.

### ▶ ASIA / EMERGING MARKETS

#### China : slowing the runaway train

Following official pressure for banks to cool their lending in overheating sectors such as property, the China's central bank sprung a timing surprise on the market, tightening its required reserve ratio by 0.5% rather earlier than the market had expected. The latest new loans data reflected a hefty jump from a year earlier, underlining the central bank's concerns over the possibility that asset price bubbles have developed in some sectors.

Meanwhile Brazil's finance minister predicted growth of 5% in 2010, hailing his country's success in creating nearly one million jobs last year, while predicting 1.6 new jobs this year. However, with the Brazilian economy continuing to deliver robust levels of activity, the central bank revealed plans to begin phasing out the liquidity measures introduced at the height on the banking crisis in late 2008.

## Fixed Income

Against a backdrop of investors' reassessment of risk in the wake of the Greek debt crisis and ongoing uncertainty over President Obama's bank reform plans, investors became increasingly discriminatory during February, shunning bonds issued by deficit-heavy countries, such as Portugal. However, yields in the US, Germany and the UK broadly ended the month lower. In the case of the latter, this came as converging opinion polls – one showing only a two-point lead for the Conservatives – heightened concerns that a hung parliament could reduce the political will to address the UK's spiralling budget deficit.

The Greek sovereign debt crisis and the lack of clarity over a possible European Union or International Monetary Fund bailout prompted a fresh round of risk aversion from investors, with spreads broadly widening during the month. With investors paying increased attention to sovereign risks, concerns also grew that the sheer scale of the necessary sovereign debt issuance could even crowd out corporate borrowers during the months ahead, leading to funding problems as banks scale back their lending.

### Major Bond Markets – Total Returns £ 2009/2010



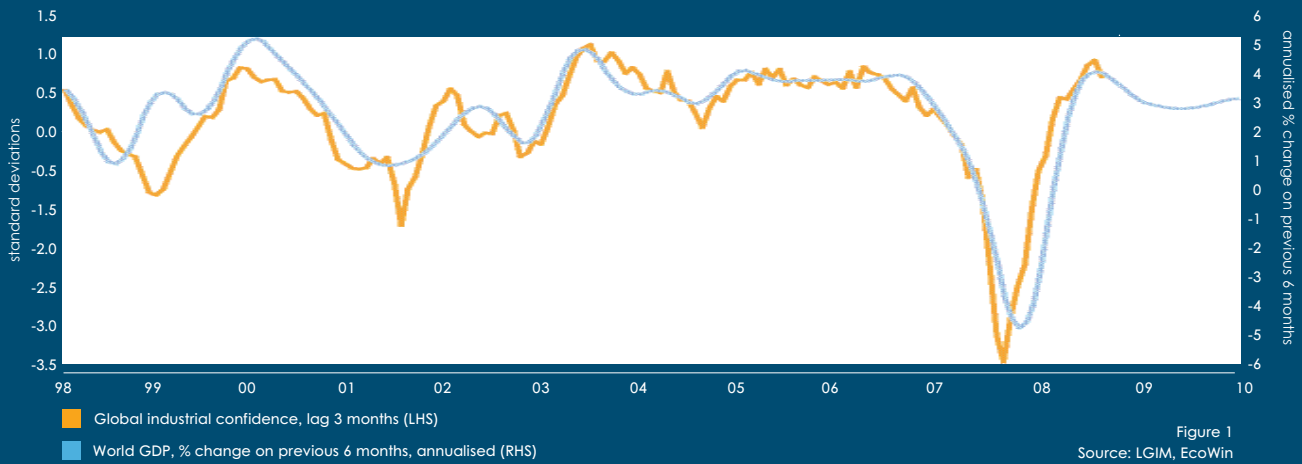
Figure 2  
Source: Datastream

# Snapshot

## Global business confidence is peaking

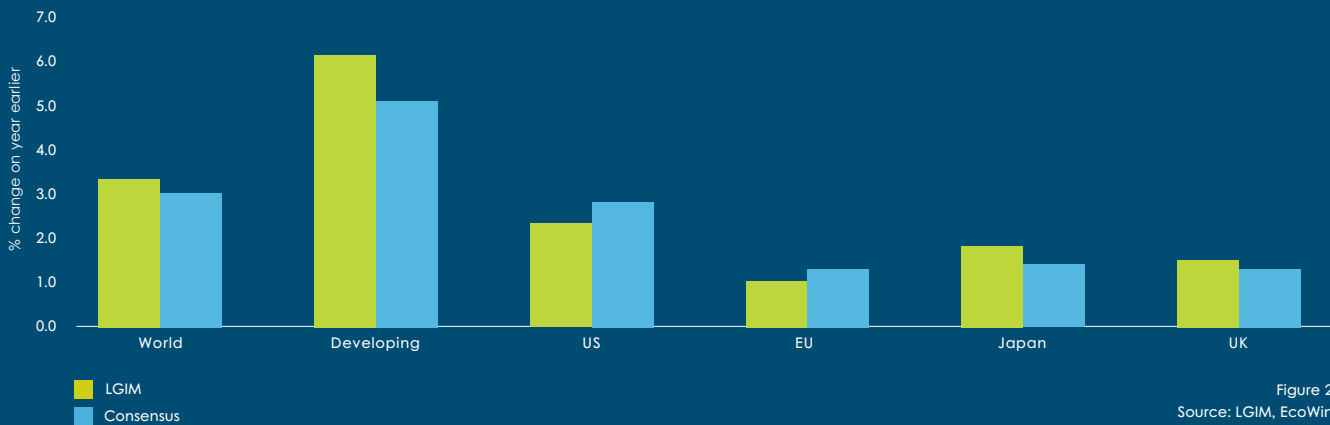
As we expected, global GDP strengthened significantly in the second half of last year. This has coincided with a rise in global business confidence surveys to historically high levels. We believe much of this growth reflects the end of destocking. Production has grown rapidly to catch up with final sales, following the collapse in output during the financial crisis. This effect is most pronounced in the US where inventories accounted for most of the large rise in 4Q09 GDP. But this is a one-off event. Once inventories have stopped falling, production growth will need to slow to the pace of final sales growth to prevent inventories from building. It is possible that firms will choose a short period of restocking and this could keep production growth strong for a few more months, but some slowdown now seems inevitable. This is likely to be reflected first in business confidence surveys stalling and then moderating to more normal levels (Figure 1).

Global industrial confidence is peaking as global GDP slows



The boost to growth from inventories is now fully reflected in consensus estimates for GDP this year. On a global basis consensus has now caught us up (Figure 2). We remain more optimistic about prospects for emerging markets, but suspect consensus will revise up their estimates following strong GDP growth in 4Q09. For the developed world we are starting to become more cautious. We are concerned that final demand is not going to accelerate as fast as is hoped, particularly in the US and the euro area. We doubt labour income growth will be sufficiently strong to offset waning government support and this will undermine consumer spending. We also expect businesses to remain cautious about investment plans in an environment of ample spare capacity.

Consensus has caught up with LGIM and in some cases overshot growth estimates for 2010



## UK Forecast

## Growth revised lower

UK Economy	Price Inflation (HICP)		GDP (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro	
	2010	2011	2010	2011	End 2010	End 2011	End 2010	End 2011	End 2010	End 2011	End 2009	End 2010
Market participants forecasts	%	%	%	%	%	%	%	%				
High	3.00	2.40	2.20	3.05	5.04	5.13	2.00	2.75	1.77	1.77	0.97	1.03
Low	1.70	0.80	0.40	1.40	3.40	4.40	0.50	0.50	1.31	1.48	0.82	0.77
Median	2.50	1.70	1.20	2.05	4.50	4.75	0.75	1.25	1.62	1.62	0.87	0.86
Last month median	2.40	1.78	1.20	2.10	4.50	4.80	1.00	1.75	1.65	1.65	0.85	0.84
<b>Legal &amp; General Investment Management</b>	<b>2.60</b>	<b>1.40</b>	<b>1.60</b>	<b>2.00</b>	<b>4.50</b>	<b>5.00</b>	<b>0.50</b>	<b>1.00</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>

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.

Latest data show the UK economy grew slightly faster during the fourth quarter than earlier estimated. The upward revision was largely attributable to a bigger boost from inventory restocking than first estimated. Recently revised data also show that business investment was weaker than originally thought.

Together, these revisions indicate to us that the temporary boost to growth from businesses restocking goods and services after the dramatic cost cutting experienced during the crisis, will end earlier than we previously thought. As a result, we have revised down our GDP forecasts for 2010 to 1.6% (from 1.7%). This still places us ahead of the median market participant (who has growth at 1.2%). Consensus estimates for 2011 have been revised down slightly during the month and are now largely in line with our call of 2% growth.

The latest inflation figures show CPI rising to 3.5% in January. In Mervyn King's letter to the Chancellor, the breach of the inflation target was explained by the rise in VAT and energy prices compared with a year earlier. These effects are likely to be temporary and the MPC expects inflation to fall back to the target in the second half of the year. We agree inflation pressures will ultimately subside through 2010, gradually rising through 2011.

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