Fundamentals

Economic and Investment Commentary

September 2007

Legal & General

Investment Management

Overfed

Financial markets corrected over the summer, as we predicted in our July Fundamentals. In this issue, James Carrick, investment strategist at Legal and General, examines whether now is a better time to buy equities or if further weakness is likely. By outlining the four key drivers of market performance (profits, interest rates, valuations and sentiment), he argues that markets should remain volatile with only modest gains expected. In particular, a lack of spare capacity should still discourage central banks from cutting interest rates as much as markets hope and depress profits. So the post-Fed rally could fade.

Inside:

Back in July we argued that high government bond yields could hurt financial markets. This duly happened. The credit market dried up as indebted firms struggled to raise finance. This, alongside continued US mortgage default fears, led to banks experiencing a shortage of liquidity as they were unable to sell asset-backed securities. So weaker financial stocks led equity markets lower.

Now that the Fed has surprised markets with an aggressive 50bp cut, is today a good time to buy equities? Or, like we saw with the accounting scandals of 2001 and 2002 (such as Enron and Worldcom), will markets turn sour again as more problems emerge?

STYLISED ASSET ALLOCATION CYCLE

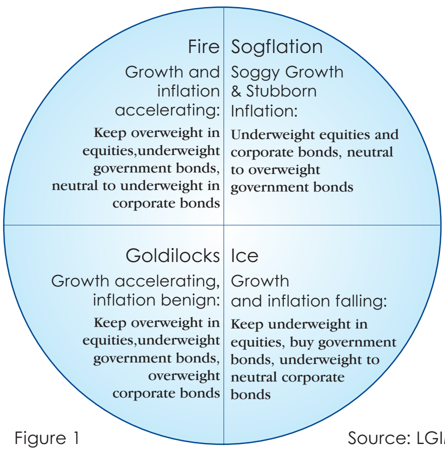

Figure 1 Source: LGIM

Asset allocation cycle

When judging the outlook for equities over a 12-month horizon we look at four key indicators: profits, interest rates, valuations and sentiment. We think equity valuations are attractive as we do not expect to see a recession. But we still see interest rates being cut less than markets expect, despite the Fed's aggressive 50bp cut on 18 September. We also see earnings forecasts being revised down, even under our soft landing scenario. And although investor sentiment is less bullish than at the start of the year, it isn't bearish either. So we expect markets to remain volatile with only moderate gains expected over the next year.

Fundamentally, we believe we have entered the 'sogflation' stage of the economic cycle, a period of soggy growth and stubborn inflation (Figure 1). In this environment equities typically struggle as

GLOBAL MANUFACTURING CAPACITY UTILISATION RATES ARE SIGNIFICANTLY ABOVE AVERAGE

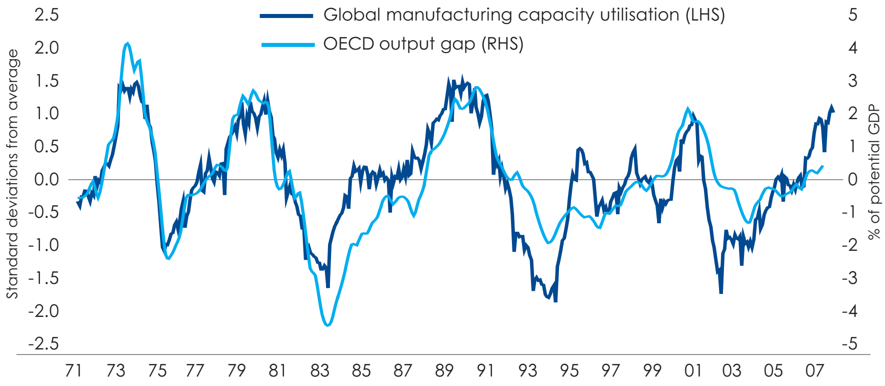

Figure 2 Source: Reuters Ecowin, LGIM

the cost of capital remains relatively high at a time when profits slow. Indeed weaker asset prices are one of the main ways in which central bankers slow their economies down.

By contrast, the best time for profits and financial markets is the 'goldilocks' stage. This is when economies grow rapidly and there is plenty of spare capacity. So revenues soar at a time when labour and raw material costs are cheap. This is where we were in 2003-04 and 1999.

After a while, we move into the 'fire' stage. Economies continue to grow rapidly but shortages of labour and raw materials emerge. Profits continue to grow during this period, but at a slower pace because a greater share of revenues goes to workers and suppliers. This is where we were in 2000 and where we have been since 2005 (Figure 2). Inflation rises and central banks tighten policy.

Higher interest rates ultimately push the economy into the 'sogflation' phase. Growth slows below trend (becomes soggy) but cost pressures remain high. This causes a sharp slowdown in profits. This is where we were in 1H01. Eventually, the economy could enter an 'ice' period like we saw between 2H01 and 2002. Revenues are weak but at least cost pressures fade as unemployment rises and shortages of commodities and capital equipment turn into gluts.

Profits

The key issue for our corporate profits forecast is therefore which stage of the economic cycle are we about to enter. The most optimistic investors believe that we're about to enter a 'goldilocks' period of accelerating growth and low cost pressures. Some think that we're about to enter an 'ice age' recession. It is possible that we remain in 'fire' – the global economy remains buoyant and inflation continues to accelerate. But most probably, we believe we're about to enter 'sogflation' – a period of slower growth at a time of high commodity prices.

This is because our global macro conditions index – which combines government bond yields and credit spreads – points to growth slipping slightly below trend in 2008, but not a recession (Figure 3). This is because the recent widening of credit spreads has been largely offset by lower government bond yields. The risks to this view appear symmetric. The recent widening of commercial paper, inter-bank lending and mortgage spreads suggest effective policy conditions for companies and households could be tighter than our model implies. So a self-reinforcing deflationary bust can't be ruled out. But emerging market spreads remain historically low. So from the global economy's perspective, resilient emerging markets should help offset US housing weakness.

If we're right and the global economy merely slows rather than enters recession, it crucially still entails downward risks to analysts' profit forecasts. Below trend growth at a time of high cost pressures is not good for profits. At present, consensus expects S&P500 earnings to grow by 10% over the next 12 months. But our models suggest profits will grow by around 3% instead (Figure 4).

Interest rates

Not only could markets be disappointed by downward revisions to earnings forecasts, but they could also be upset by the pace of global policy easing. Financial markets currently expect the Federal Reserve to cut interest rates from a peak of 5.25% to 4%, a cumulative easing of 125bp. This is the same that they expected at the start of 2001 and 1998 (Figure 5).

But unlike 1998 and 2001 we haven't seen a global economic downturn.

OUR GLOBAL MACRO CONDITIONS INDEX POINTS TO SLIGHTLY BELOW TREND GROWTH IN 2008

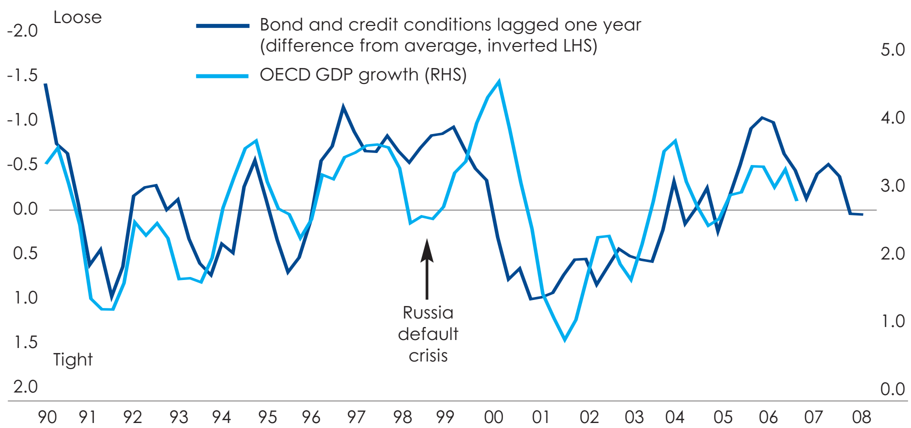

Figure 3 Source: Reuters Ecowin, LGIM

PROFITS FORECAST

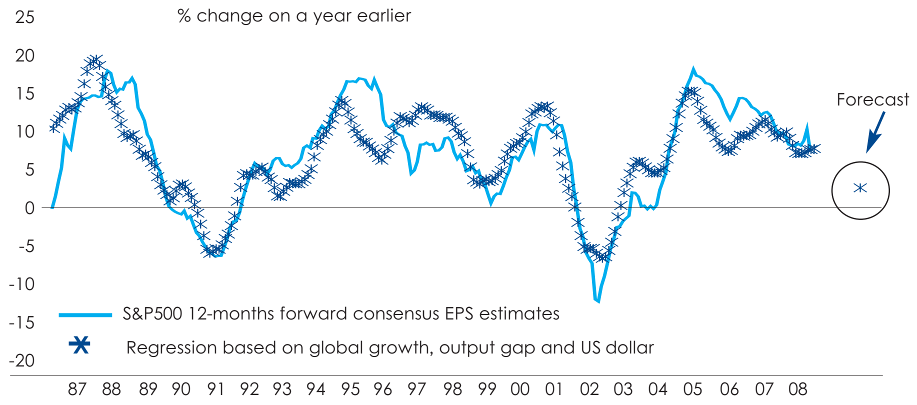

Figure 4 Source: Reuters Ecowin, LGIM

Emerging economy industrial confidence has remained robust over the past year, keeping capacity utilisation rates and commodity prices elevated. For example, at $80/bbl, the oil price is 33% higher than a year ago. But in October 1998, it had fallen by the same amount. So although the Fed cut interest rates more aggressively than markets expected on September 18 (a 50bp cut rather than a 25bp one), in the accompanying statement it maintained its concerns about inflation.

The aggressive action was designed to pre-emptively head off a credit crunch, which risked generating a recession. But the Fed made no promises to cut interest rates again. It said it wants to promote 'moderate' and 'sustainable' growth rather than aggressively reflate the economy and push growth above trend.

If the Fed is still worried about inflation – despite its collapsing housing market – other central banks will be even more concerned. The ECB and the Bank of Japan have maintained a tightening bias and the Chinese, Swiss, Swedish and Norwegian central banks have all raised rates in recent weeks. If the Fed's aggressive rate cut succeeds in stabilising financial markets then these central banks might need to raise rates further. So from a global perspective, the cost of money could still rise despite Fed easing.

Slowdown or recession?

This analysis assumes that the US economy does not enter a recession.

The downside risks to US growth are often touted. House prices will continue to fall as rising defaults lead to tighter lending standards. In turn, this will cause highly indebted consumers to cut spending to rebuild saving. This then causes firms to shed jobs and so we get into a negative spiral.

But in the short term at least, we see some positives for the US consumer, allowing the economy to muddle through. Although crude oil prices have risen lately, retail gasoline prices have actually fallen by 10% since 2Q07. And despite fears about US consumers being hurt by the expiry of 'teaser' rates on adjustable-rate mortgages (ARMS), the Federal Reserve estimates that the effective interest rate paid by US consumers on their mortgage debt actually fell in 1H07 because a large number of households refinanced to a better fixed rate deal at the end of last year.

We find labour incomes are more important for US consumer spending than borrowing and wealth. While official data showed an unexpected fall in employment in August, this has yet to be confirmed by other data such as initial jobless claims. So the fall in employment might be erratic, a payback from the first half of the year when employment growth was unexpectedly strong. In aggregate, the yearly growth in employment is now consistent with the earlier slowdown in economic activity. And more timely survey data suggest economic activity has actually improved in recent months so there is little reason to expect a sudden collapse in employment and therefore consumer spending. Instead, the drag from weaker construction output should continue to keep US growth below trend, but the economy should avoid a recession.

Valuations

If we see a slowdown in growth, rather than a recession, how does our third asset allocation building block - equity valuations - look? Our analysis suggests equities are attractively priced for this scenario, suggesting there would be value in buying equities after a setback caused by higher interest rate expectations and lower profits.

In Figure 6 we plot the 12-month forward earnings yield for the S&P500 (the inverse of the P/E ratio, based on consensus earnings forecasts for the following year). This is currently giving an implied yield of 6.75%, compared

MONEY MARKETS MIGHT BE DISAPPOINTED BY THE PACE OF CENTRAL BANK EASING

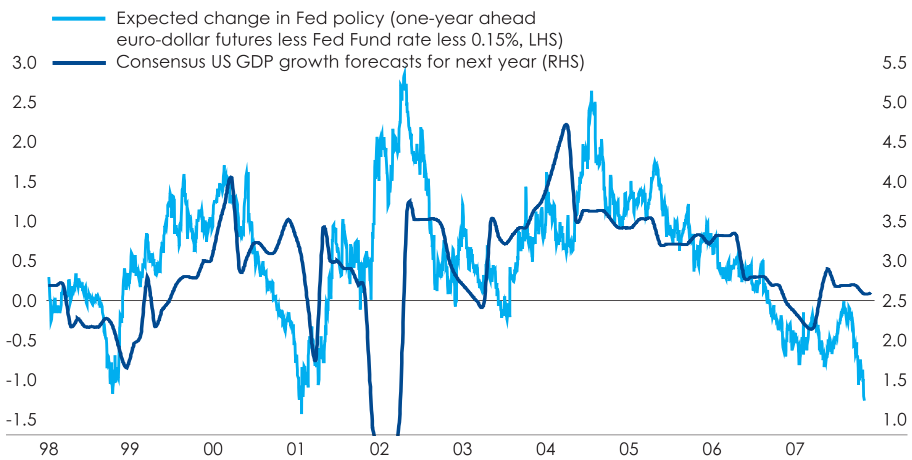

Figure 5 Source: Reuters Ecowin

EQUITIES SEEM PRICED FOR WEAKER EARNINGS GROWTH AND HIGHER INTEREST RATES

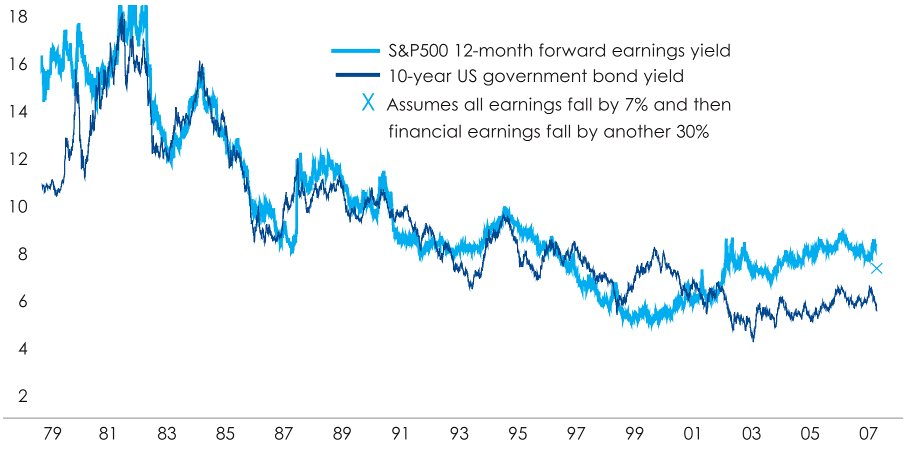

Figure 6 Source: Reuters Ecowin

with the 10-year US Treasury yield of 4.50%. So there is plenty of room for earnings to fall and interest rates to rise already factored into equity valuations. For example, if we assume 7% weaker earnings (recall our forecast for earnings growth is 3% next year against market expectations of a 10% rise) and asset-backed security problems cause a further 33% fall in financial earnings (the same they fell in the early 1990s), the equity earnings yield would still be around 5.50%, 100bp above government bond yields. So there is plenty of room for disappointment on the pace of interest-rate cuts.

By contrast, in early 2000, the implied forward equity earnings yield was less than 4%, compared with government bond yields of around 6.50%. So it didn't make sense to hold equities then. But equities do seem to offer value now, so long as we don't experience a sharp or deep recession.

Market sentiment

The final building block of our asset allocation process is market sentiment. There are a variety of different indicators that can be used to judge this. For example, the ratio of equity market calls to puts, the amount of directors' share purchases, and the relative performance of 'cyclical' stocks and markets to 'defensive' ones. Morgan Stanley produce a long-run risk indicator based on mutual fund flows into equities, analyst upgrades and money supply growth (Figure 7). At the start of the year, this was above its long-run average, suggesting sentiment was positive. Historically markets have not performed well when this indicator has been high. While sentiment has moderated over the summer, we would prefer it if investors and analysts had capitulated at a time when fundamentals were good. The markets reaction to the Fed rate cut suggests they are looking forward to a period of lower interest rates and faster growth but they might be disappointed on both fronts.

Conclusion

So the four building blocks that go into our asset allocation process – profits, interest rates, valuations and sentiment - are suggesting a modestly cautious stance. We think that investors will be disappointed by the pace of rate cuts, so liquidity concerns might not disappear entirely. We believe central banks – including the Fed – don't want to see above-trend growth. Instead they want to hold it steady at a moderate pace to ease inflation pressures. Weaker financial markets are one way to achieve that. So analysts might also have to revise down their growth and profit forecasts from here. Investor optimism could therefore deteriorate further. So while valuations are attractive, volatility is likely to remain high.

If we are wrong on any of the assumptions made, our asset allocation process can guide us as to the likely market response. For example, if the Federal Reserve ignores the strength of the global economy and continues to cuts interest rates aggressively to stabilise the housing market, interest-rates would fall in line with consensus and we would have to revise up our global profits forecast, so equities would look more attractive. Conversely, if we are wrong on the 'soft landing' scenario, and the global economy is about to enter a recession, then equity valuations might not be as attractive as we think. So we will continue to monitor the economic data closely – particularly the health of the labour market – as well as policymakers' attitudes to growth and inflation to judge the outlook for equity markets over the next year.

MORGAN STANLEY'S RISK INDICATOR SUGGESTS INVESTORS AND ANALYSTS ARE LESS OPTIMISTIC THAN BEFORE, BUT HAVEN'T CAPITULATED YET

CAPITULATION INDICATOR – Risk Indicator:- A Good Entry Point

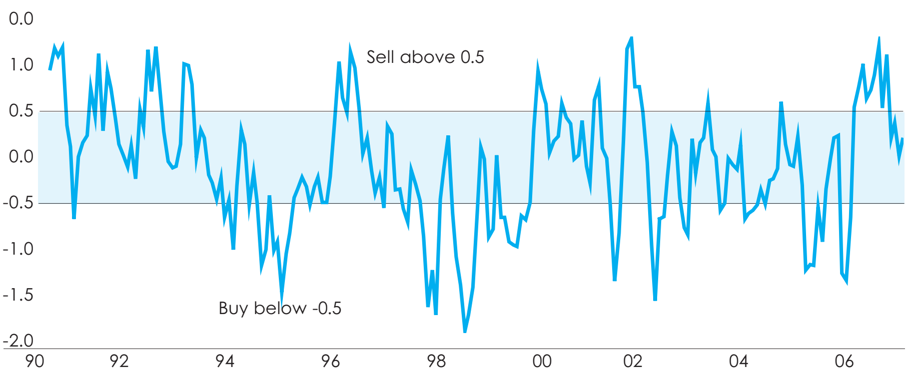

Figure 7 Source: Morgan Stanley

Market Overview

World credit crunch attacks banks

August was a month of cash problems for the world's banks. Demand for asset backed securities dried up as sub-prime mortgage defaults continued to rise. With banks unable to sell commercial paper backed by such assets, the Federal Reserve was forced to step in to alleviate liquidity pressure by lowering the discount rate by 50bp to 5.75%. This is the rate that banks can borrow short term funds directly from the central bank, and although called the discount rate is actually at a premium to the Interbank rates on offer. The move was to help the banks to raising money as problems in the sub-prime mortgages had spread to the asset backed commercial paper, affecting money market funds across the globe.

The US also showed serious signs of slowdown as the economy unexpectedly lost jobs in August for the first time in four years, sending stocks around the world tumbling. This led to the US Federal Reserve cutting its key target rate by 50bp at the 18 September meeting.

London

Positive outlook but troubled waters ahead

The turmoil in credit markets led to significant falls in equity markets by mid-month, but a recovery in the second half of the month saw the UK equity market deliver a total return of -0.3%. Increased risk aversion saw small caps fall by 2.7%. Not surprisingly defensive stocks and sectors such as Telecoms, Utilities and Tobacco performed best whilst Financials such as Banks and General Financials were hardest hit on credit crunch concerns. The main corporate news was ICI's acceptance of an improved cash offer from Akzo. Elsewhere there were trading disappointments from Cadbury's and British Energy. Whilst our concerns of a short term correction have proved well founded, we maintain a positive long term view on the UK equity market, based on a central assumption that the current credit market turmoil will not have a significant impact on the global economy.

MAJOR EQUITY MARKETS – TOTAL RETURNS £ 2006/2007

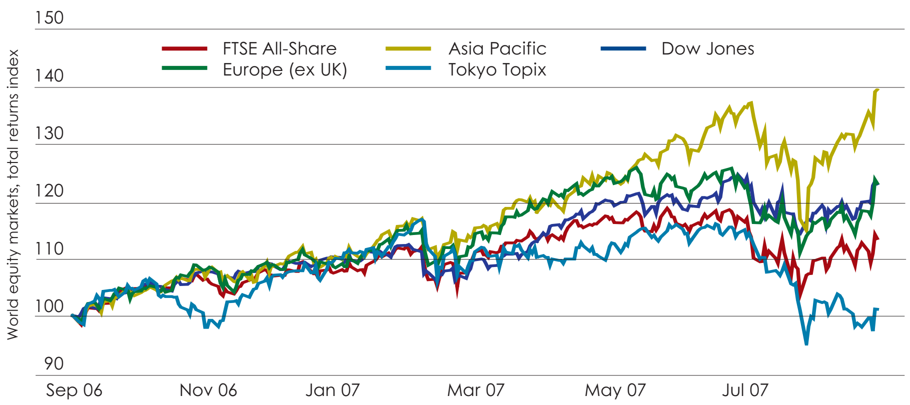

Figure 1

Source: Datastream

Wall Street

I've got a brand new combine harvester

The S&P 500 was up 1.29% in August. Equity markets rebounded slightly after central banks provided liquidity to the banking system.

The tone in the commercial paper market turned decidedly negative in August. Some financial institutions struggled to access short term capital, which led to solvency concerns. The Federal Reserve injected excess liquidity and reduced the rate at which it makes short-term funds available to member banks. Investors now expect the Federal Reserve to reduce target overnight rates at its September meeting.

The S&P 500 posted 10% (year on year) earnings growth for the second quarter. Technology bellwethers Cisco Systems, Hewlett-Packard and Dell posted better than expected results. Tractor manufacturer Deere & Co posted robust revenues and profits. Rising farm incomes should lead to higher farm equipment spending in 2008.

Investors are anxiously awaiting results and commentary from the investment banks in September. These meetings will shed some light on the credit market turmoil and the size of mark to market losses.

Outlook

The turmoil in the credit markets and the rapidly deteriorating US housing market are formidable obstacles to further market gains in the near term. On an intermediate to longer term basis, inflation remains contained and corporate profits and balance sheets remain healthy. Employment growth, consumer spending and the Fed's policy response are the key unknowns at this stage.

MAJOR WORLD BOND MARKETS – TOTAL RETURNS £ 2006/2007

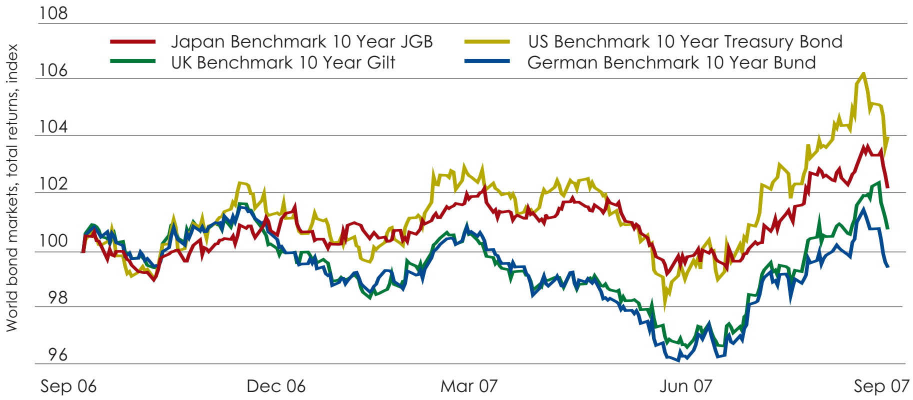

Figure 2 Source: Datastream

Europe

A tale of two stories

August really was a month of two halves. Sub-prime credit market woes took the market down 6.8% in the first half; before a number of Central Banks took action to calm fears resulting in a 6.4% rally in the second half. The main European indices finished the month around 0.7% lower.

Although sub-prime concerns had been causing worries in the equity markets before August, BNP's announcement that it had closed 3 hedge funds for redemptions due to valuation difficulties caused more of a panic amongst European financials. The European Central Bank (ECB) temporarily injected huge amounts of liquidity into the financial system mid-month which, along with a cut in the discount rate by the US Federal Reserve, calmed the equity market. Ben Bernanke, Chairman of the Federal Reserve, stated that he stood ready to take whatever measures were necessary to lay the foundation for the rally in the second half of the month.

Underwritten by Mr Bernanke's comments, the equity market feels a lot steadier going forward. Market watchers are concerned that a substantial amount of commercial paper needs to be refinanced during September and fear that this may put the market under renewed pressure, however with corporate balance sheets generally very strong these concerns may be overstated. Corporate news flow, away from the financial sector, remains generally very positive and growth in Europe remains robust. Companies exposed to Europe and emerging markets, with strong balance sheets, are likely to remain in favour and financials and those exposed to the US consumer are likely to continue to underperform.

Japan

Carry off

The Japanese markets have had a turbulent time at the mercy of the US sub prime fall-out during the summer months, on the view that such an export-driven market will suffer should the situation in the US result in recession. Rising risk aversion has also led to a sharp unwind of the carry trade, causing the Yen to strengthen against all major currencies and posting near a 9% appreciation from multi-year lows in June against the USD. Investors in Japan are closely watching the US policy makers to see whether rate cuts are now likely. Domestically economic data has been once again mixed with April to June GDP showing negative growth, due to personal consumption remaining weak and a fall in capex. Despite the weak numbers it is unlikely that Japan is on the brink of recession. In part GDP growth was reacting to strong gains from the previous two quarters and is expected to re-accelerate.

Pacific Basin

China ignores sub-prime woes

In August the FTSE AW Asia Pacific Index fell 1.3% in sterling terms. August was a volatile month as investors continued to fret over the consequences of the sub-prime debt issue in the US; markets rebounded following the 50bp cut in the Federal Reserve's discount rate on 17 August.

The region was led by China (+7.6%) and Hong Kong (+2.9%) despite a hike in interest rates. The central bank raised benchmark one year deposit rates by 27 bps to 3.6% and lending rates by 18 bps to 7.02%. Investors perceive that China and Hong Kong will be "safe haven" markets least impacted by any slowdown in US consumption. Furthermore on 20th August China's State Administration of Foreign Exchange Control announced that Chinese individuals will be permitted to buy stocks traded on the Hong Kong stock exchange through the domestic institutional investor scheme (DII). Until now, Chinese investors were not allowed to invest abroad.The laggard markets were all the smaller South East markets, Indonesia (-4.7%), Thailand (-6.1%), Philippines (-6.6%) and Malaysia (-7.9%) hit by a rise in risk aversion.

Asian markets have shown their vulnerability to external macro headwinds despite the continuing robust earnings forecast, as investors have begun to question the outlook for 2008. At the macro level we believe that any weakening in US consumption in response to the decline in US housing activity and associated credit stress, will negatively feed through to Asian economic growth. However, the magnitude may not be as severe as in past episodes and Asia's absolute GDP growth will remain robust.

Snapshot

Bye Bye Buy to Let

This month has brought the news that UK lender Victoria Mortgages has gone into administration and that Kensington Mortgages is no longer offering 'second charge' mortgages (also known as secured loans - used to finance an extension, buy a new car or follow Carol Vorderman's advice and pay off your credit card loans). It is therefore worth looking at the increasing role of 'other specialist mortgage lenders' (OSL) and the implications for the buy-to-let boom.

The Bank of England splits mortgage lending into banks, building societies and other specialist lenders. According to a Bank of England article, other lenders account for a substantial share of lending to sub prime and buy-to-let markets.

The sub-prime market share of total UK mortgage lending has risen from around 5% in 2001 to 20% now. They are particularly strong in lending for house purchases, and the rise in their share of lending fits in with the rise of buy-to-let mortgages (5% to 23% over the same period - see Figure 1).

RISE IN NUMBER OF BUY TO LET MORTGAGES

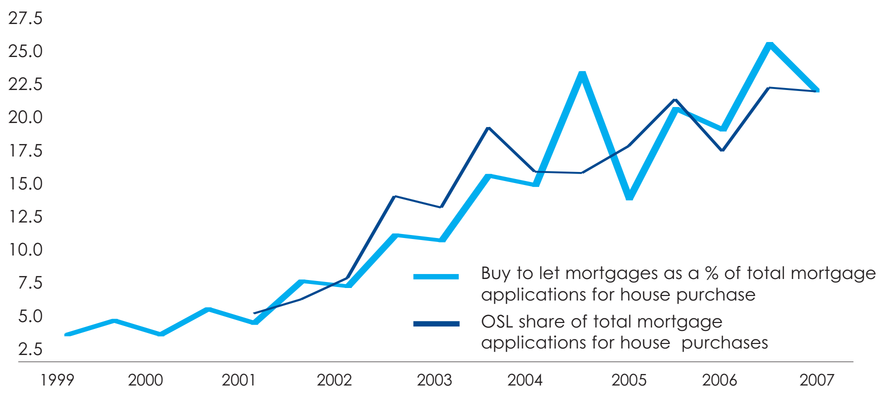

Figure 1 Source: Reuters Ecowin

There are two schools of thought over price increases; first the lack of supply of housing has been pushing up prices, second and possibly a more accurate truth, that there has been excess demand as first time buyers have had to compete with investors who have preferred bricks and mortar investments to volatile stocks and shares. So rent inflation has been modest while soaring house prices have depressed yields. The recent turmoil in financial markets and the spike in LIBOR rates might be finally hurting the investor end of the market.

At the start of the year we identified three key things to watch for the UK economy - the health of the euro area, global financial markets and the housing market. We believed it would take time for the UK housing market to react to higher interest rates as the Bank of England was acting in a timid fashion. This analysis proved largely correct as some MPC members grew frustrated at the resilience of the domestic economy and continued to raise rates. But at last, things seem to be hurting. The latest RICS survey, see Figure 2, a key lead indicator for official housing activity, showed new buyer enquiries fell sharply.

UK HOUSING MARKET

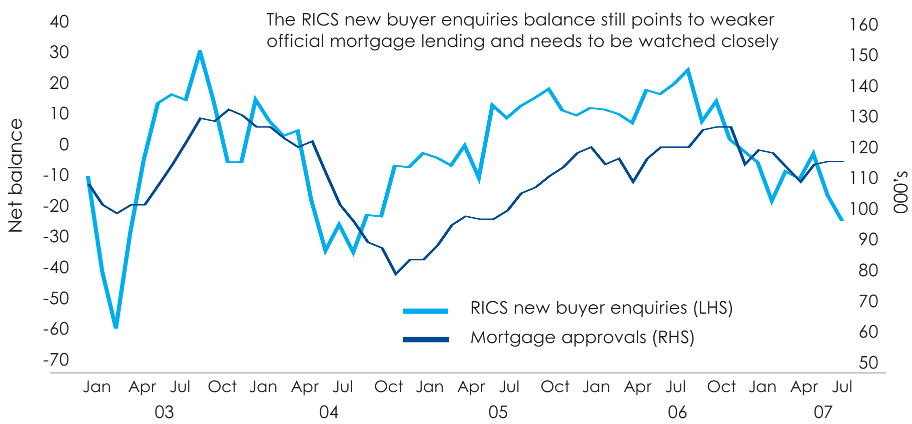

Figure 2 Source: Reuters Ecowin

We see resilience in UK exports as emerging markets and therefore the euro area remaining strong. And the rise of fixed rate mortgages means the consumer is facing a less severe cashflow impact from higher interest rates than in 2004/05. But our global monetary conditions indicator suggests OECD growth has peaked and should fall slightly below trend in 2008.

Views Commentary

Market turmoil is expected to affect economy

	Price Inflation (RPIX) End 2007 %	End 2008 %	GDP (Growth) End 2007 %	End 2008 %	Earnings (Growth) End 2007 %	End 2008 %	10 Yr Gilt Yields End 2007 %	End 2008 %	Base Rates End 2007 %	End 2008 %	$/£ End 2007	End 2008	£/Euro End 2007	End 2008	FTSE 100 End 2007
ABN Amro	3.20	3.00	3.00	2.50	6.50	7.00	5.20	5.25	5.75	5.75	2.11	2.13	0.67	0.68	7000
Citigroup Smith Barney	-	-	3.00	2.80	6.00	9.00	5.28	5.65	5.75	5.75	1.99	2.06	0.70	0.69	6800
CSFB	2.90	2.40	2.80	2.80	8.00	-	5.10	5.10	5.75	5.75	2.00	1.93	0.61	0.70	6600
Deutsche Bank	2.40	1.90	2.90	2.20	7.10	5.20	5.20	5.30	5.75	5.50	1.93	1.83	0.70	0.76	6900
Goldman Sachs	2.40	2.50	2.70	2.60	3.40	5.60	5.00	4.80	5.75	5.50	2.05	2.05	0.68	0.70	6833
HSBC Securities	2.40	2.00	2.10	1.90	-	-	4.90	-	5.75	5.50	1.99	1.83	0.70	0.74	7000
JPMorgan	2.60	-	2.80	2.00	-	-	-	-	-	-	-	-	-	-	-
L&G Investment Management	2.70	2.50	2.90	2.60	8.00	8.00	5.40	5.30	6.00	6.00	2.00	2.00	0.69	0.69	6750-6850*
Merrill Lynch	3.20	2.50	2.80	2.30	7.00	8.50	5.40	-	5.75	5.25	2.06	1.84	0.68	0.70	6400
Morgan Stanley	4.00	2.30	2.60	2.20	6.00	6.00	5.30	5.30	5.50	5.25	1.90	1.87	0.70	0.68	6550
UBS	2.80	2.90	3.00	2.40	7.00	8.20	5.50	5.55	6.00	5.75	1.98	1.91	0.68	0.70	6500
Median (ex L&G Inv Mgt)	**2.80**	**2.45**	**2.80**	**2.35**	**6.75**	**7.00**	**5.20**	**5.30**	**5.75**	**5.50**	**1.99**	**1.91**	**0.68**	**0.70**	**6800**
Last Month	2.80	2.60	2.90	2.40	6.25	7.60	5.45	5.30	5.75	5.75	1.97	1.90	0.69	0.70	6860
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 have revised down their Gilt yields forecast for 2007 as bond markets have continued to be affected by the liquidity crunch gripping world markets at the moment. After revising up their 2008 UK Base Rate forecast last month we have seen an immediate 25bp cut back to 5.50% as our survey group see the Bank of England being forced to cut rates following turbulent markets.

Market turmoil is expected to affect the real economy and 2008 RPIX inflation and 2007 GDP have both been revised down. With the dollar continuing to underperform on the currency markets the Sterling Dollar rate has been revised up for the second month in a row.

Somewhat surprisingly despite the financial turbulence 2007 earnings forecasts have been increased. But the year end target for the FTSE 100 has fallen to 6800 from 6860.

For further comment on Fundamentals, or for additional copies, please contact Harriet Moore at harriet.moore@lgim.co.uk
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