

Life after the recession

Despite the severity of the global recession, we identified in March this year that pessimism had become too extreme. Back then, we felt companies had cut back production too far and expected a significant improvement in manufacturing activity. Consequently, we felt equity and credit markets would react positively as signs of economic activity re-emerged. This dynamic is now reaching maximum strength and market participants have begun to revise growth expectations higher. However, while conditions are improving, there is a danger that confidence in the recovery rises too quickly. While the stage is set for a global economic comeback, LGIM Economist, Tim Drayson, takes a close examination into the health of the recovery and whether a potential relapse could occur.

The recession has ended

Is the recovery real or just a delusion? There have certainly been some encouraging signs. The improvement in business surveys which began earlier in the year is starting to be matched by some of the official data. Many countries recorded positive growth in the second quarter of this year and economic data should show most other major economies returning to positive territory again during the third quarter.

Financial markets have also signalled that the crisis is over. Global equity markets have risen by more than 50% while credit spreads (the difference in yield between investment grade corporate bonds and similar maturity government bonds) have more than halved.

However, while the global recession is over, investors are now debating the strength of the recovery and a number of concerns

remain on the horizon. We continue to expect demand for goods and services to remain subdued, particularly across developed countries. Households have yet to fully adjust to the credit crunch and companies are likely to remain cautious even as profits improve. As a result we believe the global economy will fall back towards its long term average in 2010. As a result, central banks are likely to keep official rates low.



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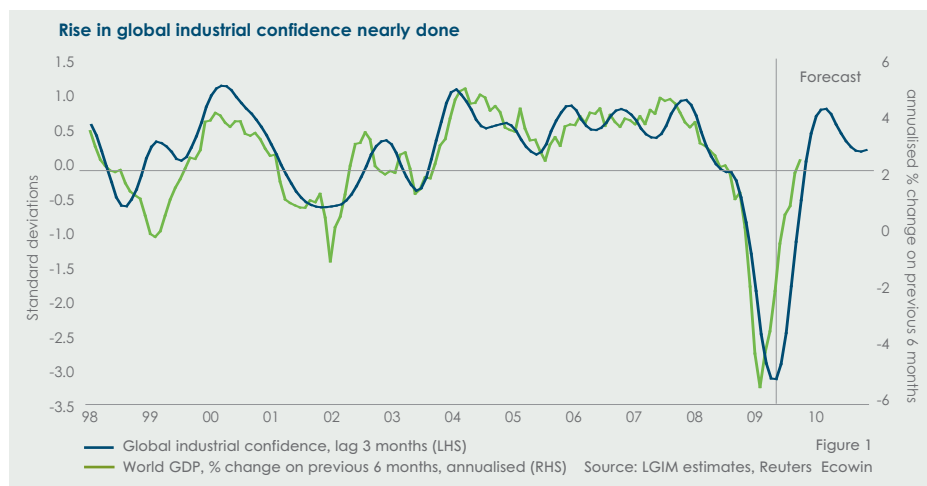
The stage is set

For some months we have been expecting a surprisingly strong economic rebound to emerge in the second half of the year. Following the collapse of Lehman Brothers last September, global demand fell sharply. But the reaction of companies to this slowdown was extreme. Faced with uncertainty about demand and a seizure in credit markets, firms chose to make dramatic production cuts and run down existing stocks of inventories. Aggressive interest rate cuts and various fiscal stimulus packages around the world helped stabilise demand for goods and services. By the second quarter of this year inventories were being liquidated at an incredible pace. This has set the stage for a major global inventory cycle with production snapping back towards demand to prevent inventory levels from becoming too low. This inventory effect could support global economic growth during the second half of this year, producing a short period of above average growth (Figure 1).

Our forecasts suggest that business surveys will continue to improve for a few more months as global industrial production expands briskly. However, we remain doubtful regarding the strength of final demand for goods and services. Once this inventory effect wears off there could be a relapse. We are not expecting a double-dip recession, just a relatively subdued growth environment with consumers increasing their savings in response to the earlier falls in household wealth, and companies reluctant to invest given ample spare capacity. This suggests manufacturing surveys could stall or even partially reverse around the turn of the year.

US to disappoint

Consensus growth forecasts have yet to fully adjust to reflect the scale of this inventory adjustment. We expect the biggest upward adjustments to be made to the economic data for the second half of this year. Arithmetically this will boost annual averages in 2010, but many forecasters could extrapolate near-term strength into a stronger quarterly profile through next year.



Consensus appears to be relatively more upbeat on the US than other developed economies (Figure 2). This partly reflects the timeliness of the surveys. The US is more widely covered and surveys are completed more frequently. But it is also because consensus has taken the view that the US has experienced the greatest policy response and combined with its much vaunted flexibility, it should recover more strongly. Finally, the inventory cycle is more clearly visible in the official US data than elsewhere. Yet we view the US as the epicentre of the crisis and where the fall-out should linger the longest.

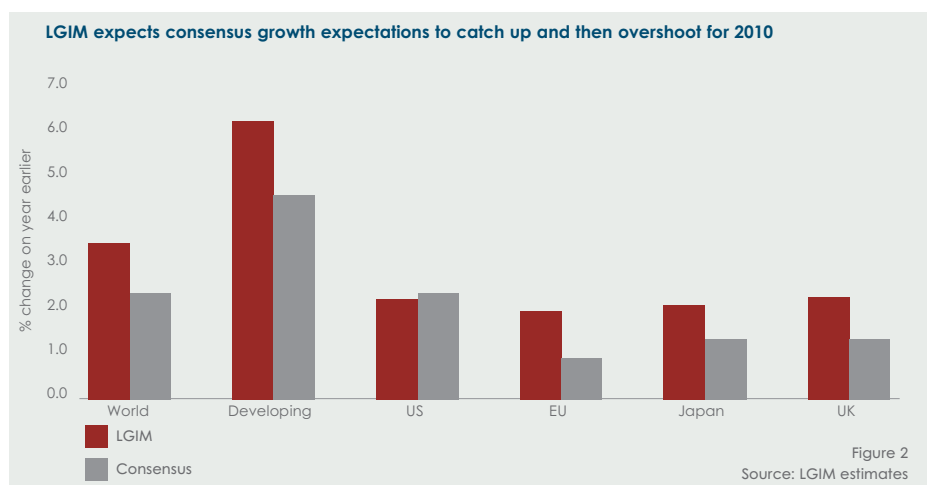
The euro-area and Japan suffered greater drops in output than the US as they are more open economies and were more exposed to the collapse in world trade. But as world trade starts to function more normally there is scope for a sharper recovery as exports rebound. Japanese

exports, particularly to Asia, are already bouncing back after catastrophic declines around the turn of the year.

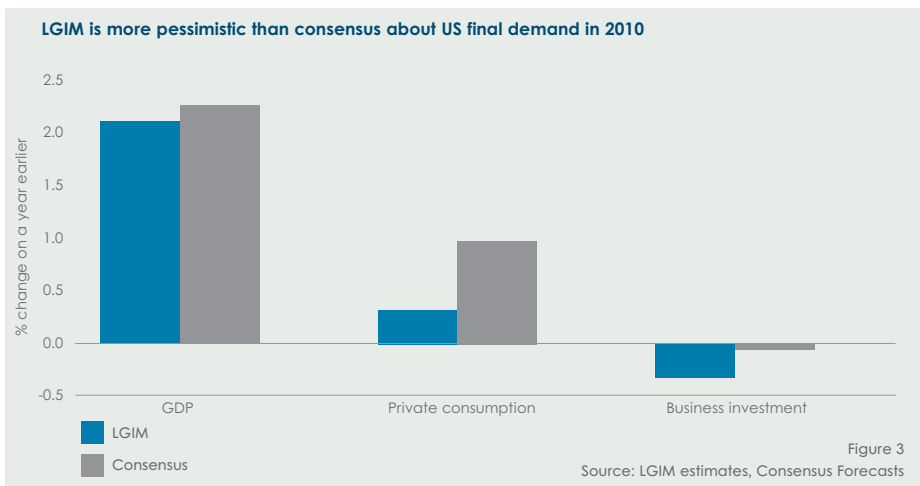
The UK economy shares many of the same imbalances as the US economy and while we have concerns about domestic demand, as a relatively more open economy, the UK should benefit from its improved competitiveness following the fall in sterling. The UK is also more sensitive to short-term interest rates than in other economies and households have benefited from a dramatic fall in their mortgage interest costs following last year's interest rate cuts.

Engines of growth

Developing economies are the one region where we are genuinely quite upbeat. We envisage these economies achieving sustainable growth even in an environment where their exports to the developed world



Article contd.



remain relatively subdued. With the exception of Eastern Europe, developing countries don't appear to be struggling with an impaired banking sector. In fact, the loosening of monetary policy could encourage the private sector to increase their debt from today's low levels. Car sales have rebounded to record highs and we expect domestic demand to be buoyant next year. China in particular could grow at almost 10% next year, even if the recent surge in loan growth were to moderate.

We are already slightly more gloomy about US prospects than consensus and strong industrial data could cause this gap to widen further over the next few months. We are especially concerned about the outlook for consumer spending and business investment (Figure 3). We expect companies to remain cautious even as corporate profitability improves, given large amounts of spare capacity. We also see a further contraction in investment in structures. Many of the projects which started before the credit crisis are now nearing completion and with financing still prohibitive and excess capacity remaining, there is little spending in the pipeline.

Government income support is fading

The outlook for the US consumer hinges on developments in the labour market and disposable income. While lending conditions are beginning to thaw, lower levels of wealth are reducing households' willingness and ability to borrow against their assets. This makes consumers more

heavily reliant on income growth to fund their spending. In the first half of this year the government gave huge support to consumer incomes through a combination of tax credits, uplifts to social security payments and one-off transfer payments. This cushioned households from the collapse in wages and salaries. Lower energy prices also helped to boost real incomes.

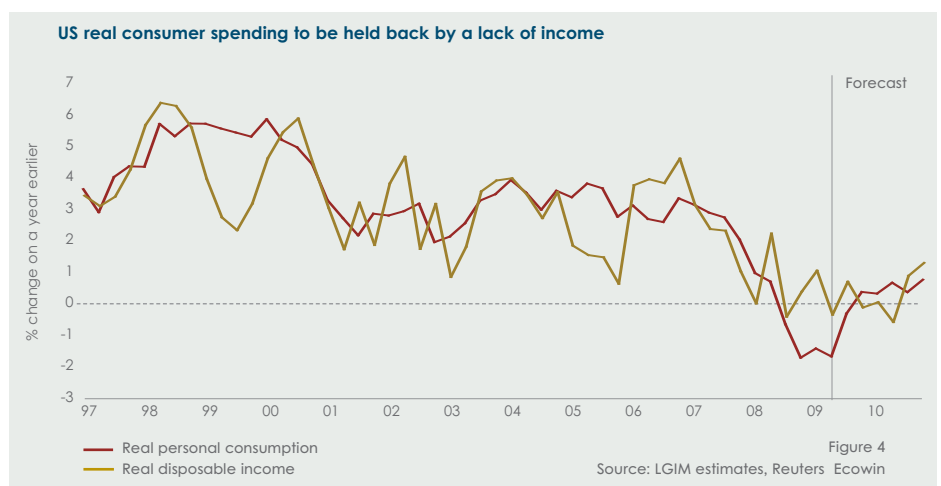
In the second half of the year the support from the government will fade and rising energy prices have already started to squeeze real incomes. We expect employment to stop falling by the end of the year, but we don't envisage a meaningful jobs recovery. This is likely to keep real disposable income growth subdued (Figure 4). There is also the risk that households choose to save more of their income in order to pay down debt, further reducing real consumer spending growth. The US Government's 'cash for clunkers'

programme appears to have been quite successful in boosting car sales, but in our view this has only brought forward consumption which would have occurred over time. As a result, car sales should now fall backwards as the programme has ended.

Housing stabilises

The good news is that the US housing market appears to have stabilised. Home sales are edging higher and prices have stopped falling. However, as long as inventory levels of existing homes remain high, we expect the recovery to be gradual. Following the collapse in home-building, residential investment is now less than 3% of overall GDP. Even if housing starts (construction on private homes) rebound, this will have little impact on overall growth. The important point, however, is that at least the drag on the economy from housing has ended.

The current rebound in global industrial production should lead to an increase in factory utilisation levels, but if growth in the US and other developed countries is slightly below potential a huge amount of spare capacity will remain. Decent growth across emerging countries should use up some of this slack, but even by the end of next year we expect global industrial capacity utilisation to only have recovered to the trough levels reached in the last economic cycle (Figure 5). This should put downward pressure on finished manufactured goods prices, even if commodity prices rise.



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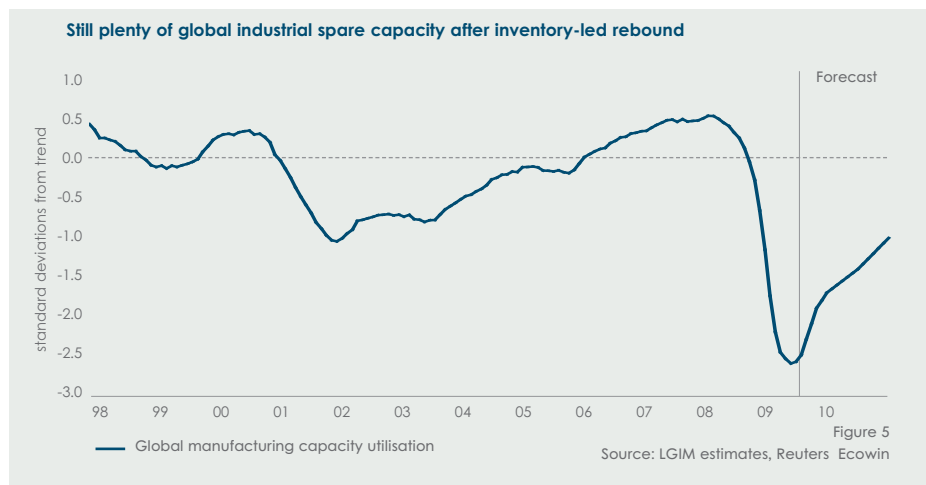
Interest rates to remain low

In the absence of a strong inflationary impulse from abroad, we expect US core inflation to trend downwards over the next few quarters. Our models suggest that the unemployment rate will probably stabilise around 10% and then start to fall later in 2010. But the large pool of unemployed workers will continue to put downward pressure on wages. Furthermore, we believe that weak consumer spending growth will limit the ability of service sector companies to raise prices.

Our model to forecast the US Fed funds rate moved into negative territory as the crisis erupted last year (Figure 6). Since interest rates can't be cut below zero, this implied a need for additional policy action and this duly arrived in the form of various liquidity facilities and quantitative easing. Our model currently indicates that these facilities and quantitative easing need to be maintained for now. The Fed appears to agree, since it has recently announced an extension to many of its programmes. Later in 2010 and into 2011 we think some of this liquidity will need to be taken back. Some of this will happen automatically as programmes expire. But crucially we don't see any need to raise interest rates until 2011 at the earliest.

The dollar is the main risk to this view. If foreign investors feel the Fed is being too slow to withdraw liquidity or if fears about the long-run sustainability of the public finances surface, this could undermine the dollar and raise inflation expectations. In this environment the Fed might feel it has to act earlier than it had planned.

Our analysis leads us to expect similar approaches from the other major central banks. We see inflation falling below target in the UK and the euro-area with Japan mired in deflation. In the absence of a sustained period of above-trend growth and a substantial fall in unemployment we see little prospect of interest rate increases in 2010. A final reason for expecting exceptionally low interest rates to continue for some time is



that the boost from fiscal policy should fade through 2010 and in some cases could become contractionary. If governments are cutting spending or raising taxes, there will be less need for central banks to restrain growth.

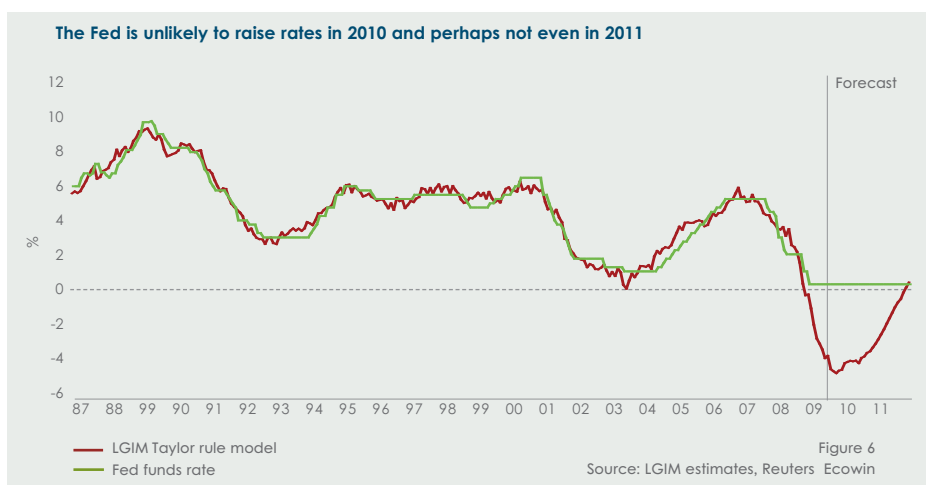
Monetary tightening should start first in emerging markets as their recovery is likely to be stronger as their domestic credit markets are functioning better and they are likely to encounter capacity constraints sooner than in developed countries.

A 'square-root' shaped recovery

We expect the positive economic news flow to continue for a few more months. The recovery in global industrial production has only just begun and there is still a large gap which needs to be closed between output and demand.

It is possible that a self-sustaining recovery results from a turn in the inventory cycle. Much depends on the willingness of the companies to hire and invest.

If we are right about the lack of underlying final demand growth across developed countries then we could see a renewed setback in market confidence later in the year or early next year. The size of any market correction depends on how much further the current momentum persists. Rather than a sharp 'v-shaped' recovery, we believe it is more likely that the initial rebound in growth plateaus into more subdued economic gains during 2010 (a 'square-root' shaped recovery). This could also cause markets to scale back their expectations for interest rate increases in 2010.



Market Overview

Global markets have correctly anticipated the end to the recession over recent months as equities have rallied strongly and bond spreads sharply narrowed. Forward-looking confidence surveys, first to indicate better times ahead, have more recently been backed up official data confirming that several of the world's major economies are gradually returning to growth. Global trade and manufacturing data have been particularly encouraging.

Yet the unprecedented economic stimulus packages which have played a key role in reviving economic activity have come at a heavy price – according to a recent IMF report, the global financial sector has received more than \$10 trillion in government support. However, with some governments now calling for an 'exit strategy' from the stimulus programmes, we believe that the key risk is that some markets may now have gone too far in pricing in better times ahead, and that expectations could be revised lower as the stimulus effect fades.

Equity Overview

UK Lagging behind

UK equities climbed by 7.1% in August, as marked by the FTSE All Share index. In sector terms, real estate and banks lead the way, reflecting the market's view that heavy writedowns over recent quarter had left valuations at attractive levels as the trading backdrop has stabilised. The FTSE Small Cap index soared 13.1%, demonstrating investors' rising appetite for risk.

The Bank of England (BoE) held interest rates at 0.5% and extended its quantitative easing programme by £50bn, taking the total for asset repurchases to a hefty £175 bn. This decision surprised many analysts, who had expected the programme to end. The BoE clearly remain concerned about the growth outlook.

Official data show the economy contracted by 0.7% in the second quarter, but recent manufacturing data indicate that the recession probably ended around mid-year. Though house price surveys and resilient retail sales data provide grounds for optimism, some doubts linger over the sustainability of these trends against the backdrop of rising unemployment, tough credit conditions and a rising tax burden. Nevertheless, we believe that sterling weakness and many UK households'

exposure to low short-term interest rates should act as a fillip to the UK's economic recovery.

US Recovery gains traction

US equities rose by 3.4% in dollar terms during August, as measured by the S&P 500 index. This rise was supported by a growing consensus that the world's largest economy is now well on the way to recovery. Data confirmed that Gross Domestic Product declined at an estimated 1.0% on an annualised basis in the second quarter, a dramatic improvement on the 6.4% annualised contraction during the previous quarter. Data also showed inventories being liquidated faster than expected. This could lead to a relatively strong inventory-led recovery in the second half of the year, a view supported by the rapid improvement in the manufacturing ISM index. Against this brighter backdrop, in contrast to the BoE, the Federal Reserve (Fed) confirmed that it is to gradually apply the brakes to its quantitative easing programme, easing back on its asset repurchases in September and October.

As if to further reassure investors that the US economy has turned a corner, Ben Bernanke, recently confirmed for a second term as Fed Governor by President Obama,

emphasised his positive near-term view on growth, though warned that the pace of recovery will be slow during the months ahead. We echo this view that, even with interest rates close to zero, the US economy will recover only gradually. The labour market remains weak and consumer spending is likely to struggle as saving rates rise. Once the inventory and government support to growth fades, we expect growth to disappoint next year.

EUROPE Firmer than expected

European equities were at the forefront of the major western markets' advance during the month of August, with the FTSE World Europe ex UK index rising by 5.5% in local terms. As in the UK, the financial sector was among the strongest performers as Crédit Agricole, Danske Bank and UBS soared on growing conviction that the earnings backdrop has improved considerably over recent months. However, automobiles and general retailers suffered a poor month on concerns over the sustainability of consumer confidence; fashion retailer Hennes & Mauritz delivered a disappointing sales update while car giant Peugeot Citroën struggled after recently revealing swinging production cuts in the face of weak global demand.

Major Equity Markets – Total Returns £ 2008/2009

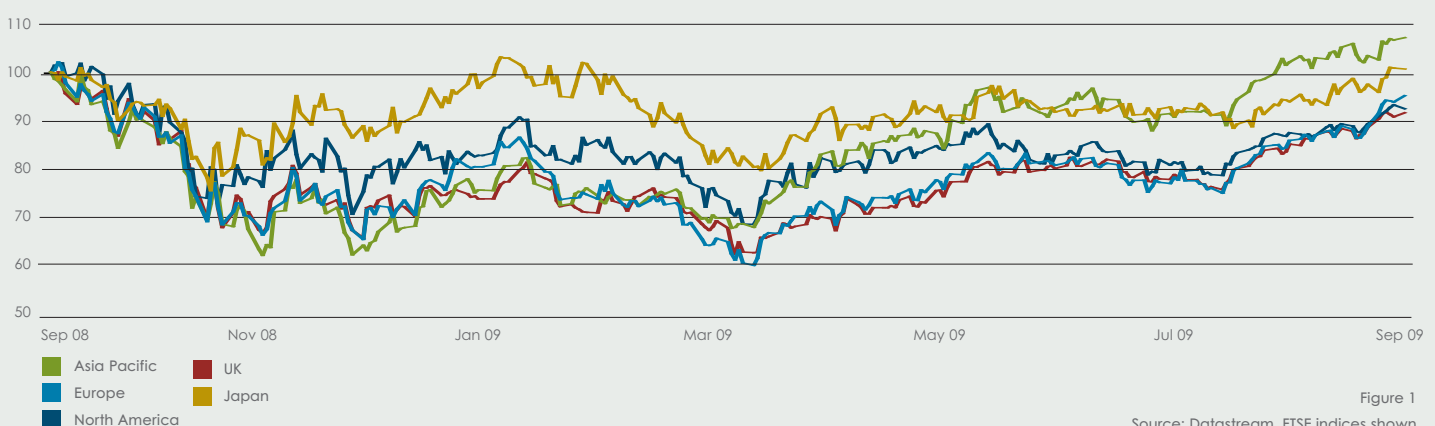


Figure 1

Source: Datastream, FTSE indices shown

Equity Overview Contd.

▶ EUROPE (CONT/D.)

Firmer than expected

Despite ongoing concerns over rising unemployment, eurozone economic data has generally continued to paint a more positive picture over recent months, with the export-orientated German economy bolstered by signs of improving overseas demand. Aided by national government stimulus measures, such as a hugely-popular car scrappage scheme, and sporadic improvements in consumer spending, rising exports have played a pivotal role in helping the German economy grow by 0.3% during the second quarter. To the surprise of many commentators, the French economy matched this performance, ending its sequence of four consecutive quarterly contractions.

The European Central Bank (ECB) kept interest rates on hold at 1.0%, as expected. Noting evidence of recovery across much of the eurozone, ECB President Trichet nevertheless highlighted the Bank's "prudent and cautious" stance. Though we agree that the depth of the region's recent downturn warrants an extended period of stimulus until the present recovery gains further

momentum, we believe that the eurozone region should be a major beneficiary of the nascent revival in global trade.

▶ JAPAN

Stimulus measures are working

Japanese equities rose by 5.8% during August, as reflected in the FTSE Japan index in local terms.

Following two quarters of sharp contraction the Japanese economy grew by 0.9% during the second quarter of 2009. The country's emergence from recession was driven by a combination of rising exports, notably to emerging economies such as China, and a massive government stimulus package which has supported a wide range of purchases such as cars and even domestic appliances.

Though the government announced a small extension to its stimulus measures during the month, the scope for further state-backed stimulus may be limited to a large extent by the fragile state of government finances. Nevertheless, we believe that considerable scope exists for the Japanese economy to positively surprise during the months ahead. Export-focused Japanese companies should be among the leading beneficiaries of improving global demand. Domestic

economic activity could also benefit from the landmark general elections of 30th August which saw the Democratic Party of Japan sweep to power following a virtually unbroken period of 50 years in opposition.

▶ ASIA / EMERGING MARKETS

Leading the economic recovery

Emerging equity markets have broadly reflected the gains of their developed market counterparts over recent months, though many continue to demonstrate high levels of volatility on the back of short-term swings in market sentiment. For example, Chinese equities, having risen strongly in June and July, suddenly corrected by more than 20%. The trigger appeared to be fears that the authorities would attempt to curb rapid loan growth. Elsewhere equities in key emerging markets such as Russia and Brazil delivered positive returns during the month of August, supported by firmer prices of raw materials such as crude oil and commodities. Looking ahead, we retain our view that rising exports and the increasing significance of the massive domestic consumer markets in countries like China, Brazil and India should be a major growth driver into next year and beyond.

Commercial Property

The commercial property market has benefited from the improving economic backdrop. There have been a number of recent signs suggesting the market may have turned the corner, with property derivatives, listed real estate and anecdotal evidence all indicating that investors have become more optimistic. Whilst property returns remained negative during the second quarter of this year, performance was much improved on the previous quarter; the market fell just -2.2% during the second quarter in comparison to a -7.1% fall during the first quarter according to the IPD Quarterly Index.

There is growing evidence that yields for the highest quality, prime assets (those with secure income streams less sensitive to changes in rent) have peaked. Yields for the market as a whole may also stabilise in the short-term in response to this improvement in economic sentiment. However, occupier markets remain tough and once the initial bounce back in economic conditions fades, we expect lower quality assets to perform poorly. This should drive a significant performance premium over the next several years for prime vs average property.

Commercial property – quarterly total returns

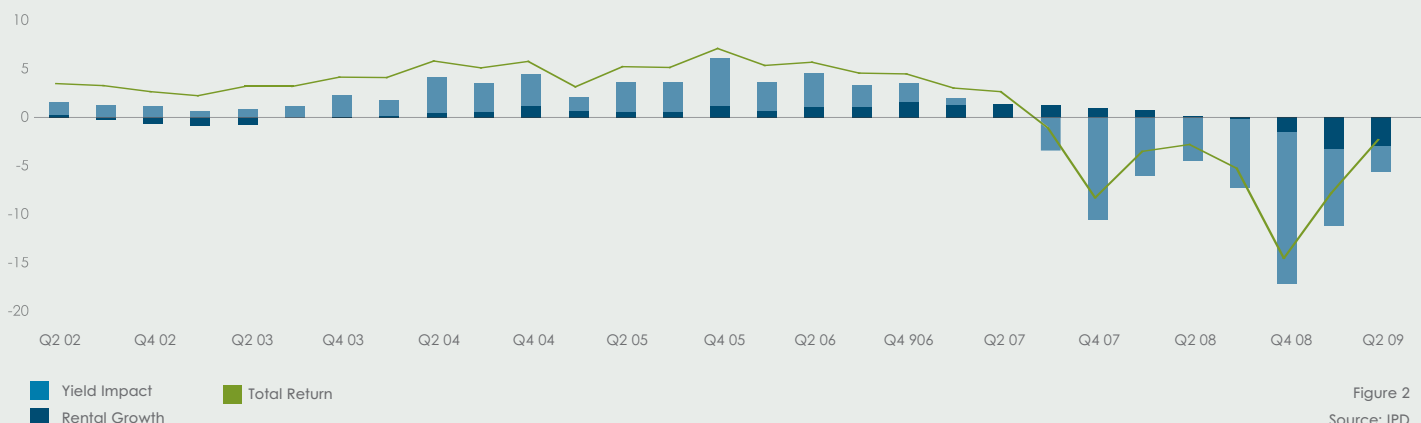


Figure 2
Source: IPD

Snapshot

Too early to exit

The UK recession appears to have ended. But to ensure the positive momentum continues the Bank of England (BoE) voted at its monetary policy committee meeting in August to extend the asset purchase facility by an additional £50bn. Although three members voted for an even larger amount, we suspect that after these purchases are finished the BoE will pause in its efforts to pump more money into the economy. But this would not signal the end of quantitative easing. It is the stock of assets the BoE owns rather than the flow of additional liquidity which determines the scale of policy accommodation.

It will take some time for the BoE to assess the impact of the measures already taken. There are considerable lags from the injection of additional money into the economy and when it affects activity and prices. While the economy has quickly returned to growth after a severe contraction around the turn of the year, there is a risk that recovery is hampered by a lack of availability of credit (Figure 1). In the absence of strong growth, economic slack is likely to remain considerable and this should keep inflation subdued over the next year or two (Figure 2).

UK GDP recovering, but disappointing outlook given the scale of the decline

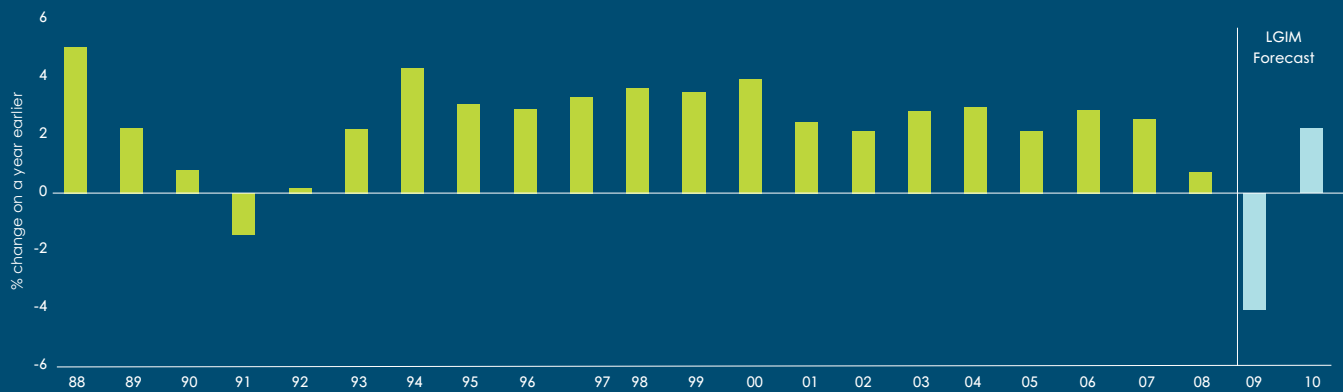


Figure 1
Source: LGIM estimates, Reuters Ecowin

But eventually policy will have to return to normal and managing the exit strategy is likely to be tricky. The biggest challenge could be attempts to sell back some of the gilts acquired through quantitative easing. This is likely to occur when government debt issuance is still running at extremely high levels. The large volume of supply could overwhelm the market, pushing gilt yields substantially higher. This would also raise the cost of borrowing in the private sector, potentially slowing growth more than necessary.

We expect UK CPI to undershoot the Bank of England's target in 2011

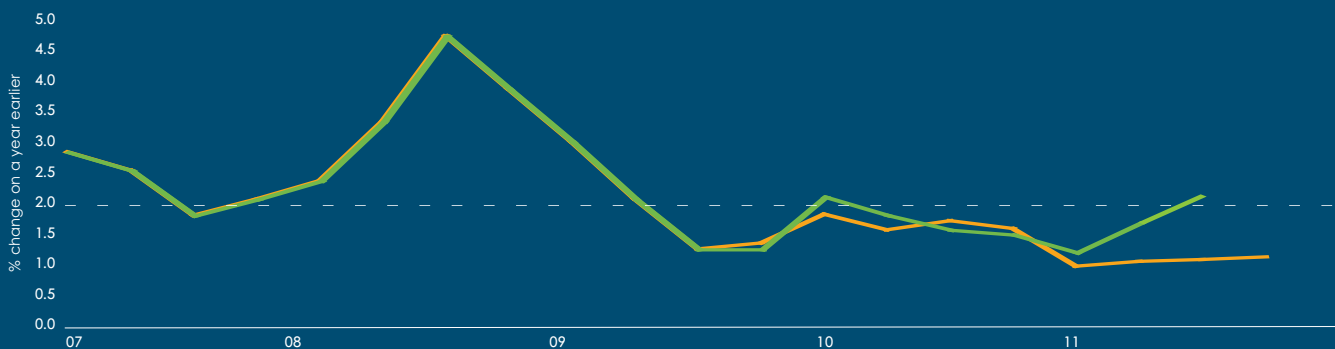


Figure 2
Source: LGIM estimates, Reuters Ecowin

Much will depend on the policies undertaken by the next government. Spending cuts and higher taxes will be unpopular, but they might be necessary to persuade investors that UK public debt is on a long-run sustainable path. The adoption of a tight fiscal policy would also tend to slow the economy down, easing inflationary pressure. This would allow the BoE to unwind its policy accommodation more gradually.

UK Forecast

Consensus continues to close the gap

UK Economy		Price Inflation (HICP)		GDP (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro	
		2009	2010	2009	2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010
Market participants forecasts		%	%	%	%	%	%	%	%	%	%	%	%
	High	2.50	2.60	-3.30	1.80	4.60	5.60	0.50	3.50	1.86	1.92	0.93	1.00
	Low	1.60	0.90	-4.80	0.0	3.20	3.20	0.50	0.50	1.44	1.49	0.78	0.72
	Median	2.00	1.80	-4.40	1.30	3.82	4.60	0.50	1.25	1.65	1.69	0.85	0.83
	Last month median	1.90	1.60	-4.10	0.80	3.60	4.68	0.50	1.50	1.62	1.67	0.86	0.81
Legal & General Investment Management		1.90	1.70	-4.00	2.20	3.50	-4.00	0.50	0.50	n/a	n/a	n/a	n/a

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 up our view on UK growth prospects over the last couple of months, but the recession is now estimated to have been deeper than previously thought. Consensus has pushed up their forecasts once again, but for now we still remain more optimistic on economic growth than the market. Recent data suggests the recession has ended. Global trade has rebounded and manufacturing activity is now increasing.

We believe we are in the first stage of a relatively weak economic recovery, where following the sharp downturn, growth rebounds relatively quickly as depleted inventory levels are restocked. The second stage, however, should be a more anaemic period of growth as credit conditions remain a drag on growth and unemployment remains high (putting downward pressure on wages). As a result we anticipate a decline of -4.0% for 2009 (down from -3.8% in July) and a recovery in the magnitude of 2.2% for 2010 (up from 1.8% in July).

The median forecast from a Bloomberg survey of market participants shows the UK economy contracting 4.4% (it stood at -3.7% in July) this calendar year, and returning to positive territory in 2010 with 1.3% growth (up from 0.8% in July).

We share a similar view to consensus on the inflation outlook and expect inflation at just under 2% next year even with the announced VAT hike pushing up the headline CPI.

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