

Fundamentals

Economic and Investment Commentary

December 2006/January 2007



Investment
Management



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Criss-cross

It's been a long strange trip for global asset markets in 2006. In this issue Julien Garran, LGIM's chief strategist, set out LGIM's forecasts for 2007, as well as highlighting some of the good, and some of the not so good calls we made for 2006.

It's been an extraordinary 12 months in global asset markets, and as the year has drawn on, it has confounded the forecasts of market strategists and economists alike. The LGIM strategy team has also had its fair share of hits and misses.

So what were the big surprises?

First, there was an extraordinary downturn in the Japanese market, followed by a surprise weakening of the Japanese consumer in the second half of the year. This contrasted with the fantastic outperformance of European equity markets – in absolute and relative terms. Here we were half right, or half wrong, as we were positive on both.

Second, credit spreads rode through the market volatility of May and June to reach new levels of tightness by late November. This, we're afraid to say, surprised even us. If there's one market that is looking

stretched, it's the credit market. So we're sticking with our views; we think credit spreads will widen in 2007.

Third, oil prices hit a new nominal peak of \$78/bbl, and then collapsed to below \$60/bbl. Several metals, such as copper, hit new all time highs before coming under pressure. Here we made the call, in May, that we felt 2006 was the peak in commodities.

Fourth, there was an aggressive sell-off in risk assets in May and June, followed by a recovery dominated by defensive stocks from July to October. Here, we highlighted our caution in advance of the sell-off – but perhaps stayed too cautious thereafter.

But what of the future? How do we see the global economy and markets in 2007?

First, the global economy. The market mantra over recent months has been

MONETARY CONDITIONS INDICATORS

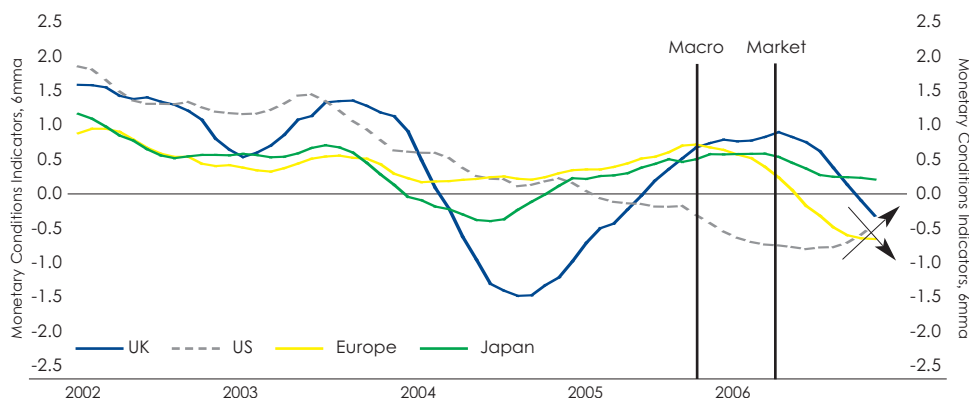
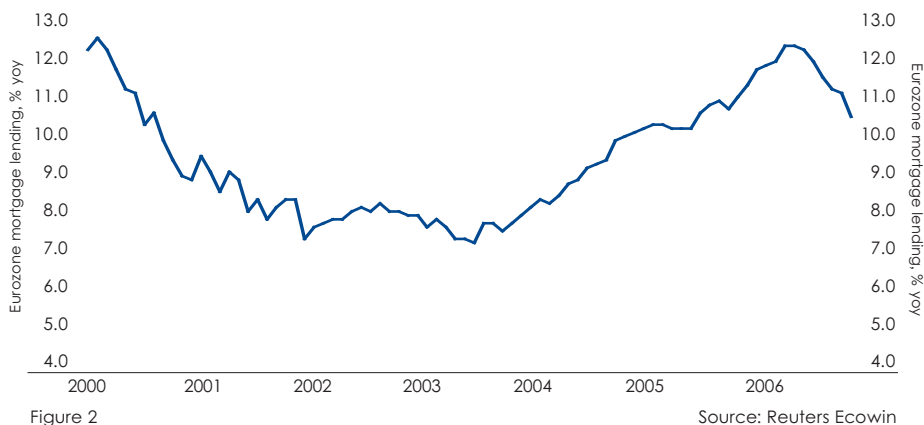


Figure 1

Source: LGIM Research

EUROPEAN MORTGAGE LENDING



years, and a significant factor behind its equity market outperformance. But just as consensus missed the power of this reflation on the way up, we suspect that consensus will miss that this power is now diminishing. The clearest indicator of this is European mortgage lending, which as Figure 2 shows, is now turning down after a three year boom.

In the US however, easier money, strong wage growth and cheaper oil should all help to support robust consumer spending, as we discussed in a recent [Fundamentals](#).

‘decoupling’. The rest of the world would hold-up in the face of a US slowdown. And for much of the second and third quarters that looked like the right call. The US slowed to sub-par growth as consumers felt the squeeze from high energy prices and as housebuilders started slashing build schedules. And everywhere else looked just fine. Asian exports held up at healthy rates of growth, and if anything, Europe accelerated.

But cracks are starting to emerge in the consensus. For one, there are tentative signs that the US consumer is recovering from its mid-year malaise. A combination of strong wage growth, lower energy and goods prices and easy financing terms are encouraging consumers back to the shops, both in the real world and in the ‘virtual’ one. This is slightly more than offsetting the clear drag from falling construction activity and broader industrial destocking – and it promises a return towards trend growth over 2007.

But just as the US may turn back up, it appears that the rest of the world might lose some momentum.

There are three reasons to be wary of the rest of the world – the first is that tighter monetary conditions have always suggested that the rest of the world would slow six months after the US – and that means around now. Figure 1 shows our ‘deep leading indicators’, based on changes in monetary conditions. These indicators, made up of short and long rates, as well as exchange rates, typically give a six month lead on the OECD leading indicators, and a

one year lead on economic activity itself. We have highlighted on the chart where the indicators are, where the macro is and where we believe the market currently stands.

Figure 1 shows that European monetary conditions are deteriorating just as US conditions are recovering. And this is yet to take account of the most recent fall in the US dollar, which will reinforce the trend.

Meanwhile, after a three year recovery, we now have a consensus that is becoming increasingly confident of a sustainable European expansion. But for us, the height of confidence in European growth is taking place just as that growth is set to slow – as export growth slows, as tax burdens rise, and as the housing market reflation in southern Europe, France and Italy weakens.

European housing market reflation was an important factor behind Europe’s powerful recovery over the past three

The US also has an inventory problem. In short, US producers of everything from cars to houses made too much and too many in the second and third quarters of 2006. This means that the US consumer will have to do some heavy lifting, while producers cut output, to help draw down inventories. We believe that this will happen. But it means that a recovery in US consumption will take six months before it boosts US goods production and thus activity in the rest of the world.

To date, Asian exports have remained remarkably resilient in the face of a US slowdown. We think we will see the delayed effects of the second and third quarter US slowdown in Asia over the next six months.

The weakest link is Japan, where slowing profit growth is undermining a consumer who receives fully 30% of their income from profit related bonuses. And if we

UK OUTPUT GAP

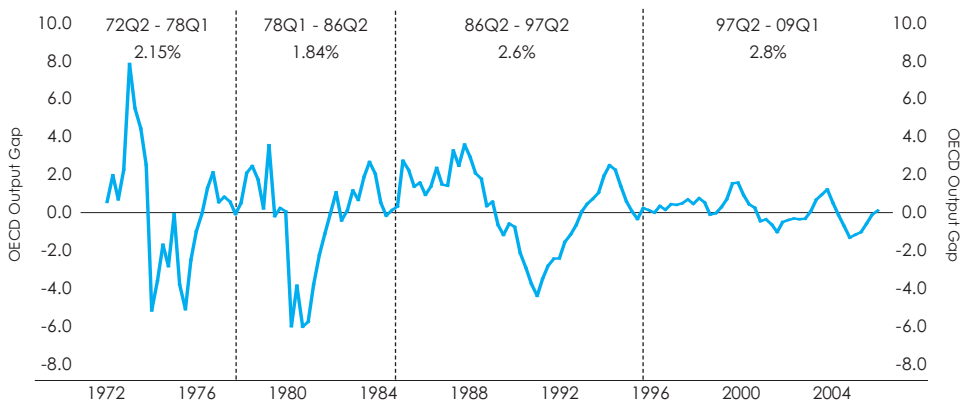


Figure 3

Source: OEW

US CURRENT ACCOUNT DEFICIT

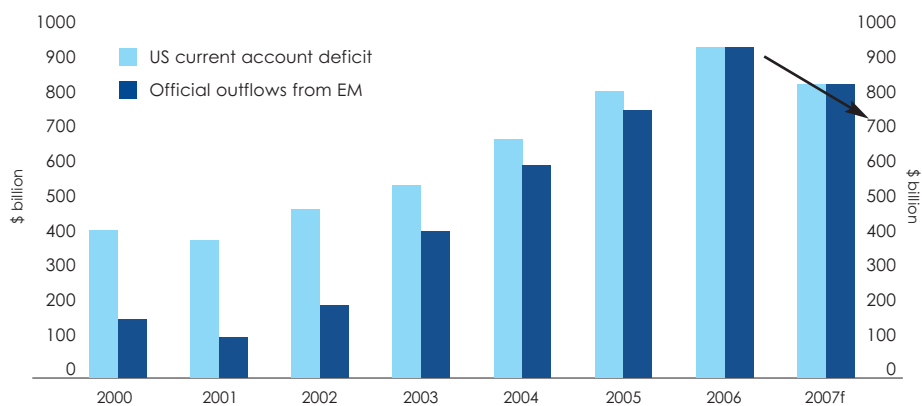


Figure 4

Source: IMF

add to that a likely slowdown in exports and industrial production, it is likely that it will be Japan, not the US that will face the toughest headwinds of the major economies in 2007.

But across Asia, there are other vulnerabilities. China has clearly embarked on a policy induced slowdown. Import growth has decelerated, and construction activity, the focus of recent legislative measures, has come off the boil. But while China is slowing, we are not bearish here – inflation remains well contained, and there is still plenty of liquidity. It is rising inflation, more than any other signal, that is the most important warning sign for China – and at the moment it's flashing green.

But the combination of moderate US, Chinese and Japanese import growth is not positive for the rest of Asia. We expect to see decelerating export growth and falling capacity utilisation. Signals of private consumption have also moderated noticeably over recent weeks. All this points to weakening Asian growth and moderating Asian export prices.

But the UK is a different story. Here we have made a big call; above consensus growth and below consensus inflation for 2007. The central issue here is that the UK is going through an acceleration of trend growth as a result of a growing labour force and rising labour force participation. This should allow the UK to sustain stronger growth than before without spurring inflation.

Two months ago we highlighted some major changes in the UK economy; immigration and the rise in older people working made us much more positive than the "gloomsters" who were focusing on unemployment only might have us believe. We now take this analysis a step further, and argue that trend growth in the UK has accelerated, and that the UK now has a claim, as yet unproven, to have the fastest trend growth in the G7.

Now, before we explain why we believe this, it might be worth asking what this could mean. There are three big market implications. First, inflation is likely to be more subdued for any given level of growth. In the short term, the next two or three years, it means that real rates will not need to rise as much to subdue inflation. But the third implication is perhaps the most interesting. UK earnings; the PE, could get rerated. And this could be very positive for those companies that derive their growth predominantly from the UK.

So why do we believe that trend growth in the UK has stepped up a gear? Three reasons. First, as we highlighted above, there has been a structural rise in older workers. Why? Perhaps because they are healthier. Perhaps because, don't laugh, they like work. Perhaps because an annuity doesn't buy what it used to.

Second, after a sustained decline, more men are working – although that partly double-counts the age effect. Third, the immigration issue. This has provided a little over half of the growth over the past five years. And while that inflow will likely slow in the years ahead, it will still continue at a decent pace. One interesting issue is that for official immigrants; those stating that they are planning to come in for over a year, over a third go into administrative and financial services jobs. And other potential factors spring to mind. In particular lower economic volatility should oil the wheels of investment decision making, thus improving the allocation of resources.

But while there are many positives, there are negatives too. The rising dependency ratios (the larger number of retired people depending on a younger workforce), the rising effective tax rates, and the rising share of public sector workers in total employment, all are acting as a drag on growth. It is despite these factors, not because of them, that we have seen an improvement in potential growth in the UK.

US IMPORT PRICE INFLATION, EX PETROLEUM

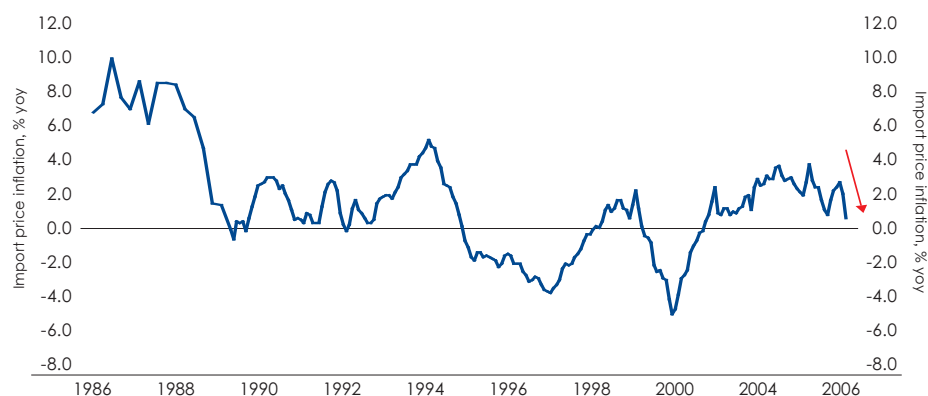
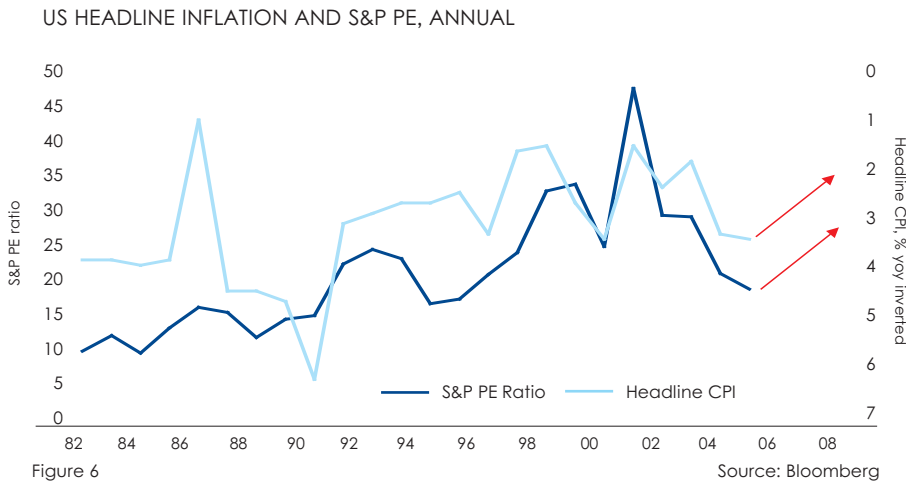


Figure 5

Source: Bloomberg



So, empirically, how much has it risen? The data suggests that from a 2.25 – 2.5% trend of the 70s and 80s, we have moved to 2.75% now as illustrated in Figure 3.

Strategically speaking

So how do we set a strategy around all this? We think that there are two critical charts. Figure 4 shows the US current account deficit against emerging market portfolio flows to the US. This money-ground is perhaps the defining macro event of the decade. The US, through its expanding deficit, has spread liquidity around the world. And the emerging markets have returned the favour, bidding up bonds, and generating a massive arbitrage for risk assets – it’s been cheap to borrow to buy everything from corporate cash flows, to commodities to leveraged credit derivatives.

But just as everyone has got comfortable with this brave new world of emerging market funding, the situation is about to change. The US current account surplus is about to shrink and with it the growth of emerging market reserves.

The deficit will shrink for three reasons. First; lower resources prices. Second, smaller government borrowing and third, a slowdown in consumer borrowing. And with the shrinking deficit will come a shrinkage in emerging market reserve growth.

To put this in context, we estimate that an oil price of around \$45/bbl will wipe

out OPEC reserve accumulation. That seemed a long way away at \$78/bbl oil. It’s not so far away at \$60/bbl. And we think that the government budget deficit will shrink. That shrinkage plays directly to reduce the current account deficit. And we think consumers will switch from saving out of appreciating assets – to saving out of income. Not aggressively, but enough to take 1pp out of the current account deficit over the next couple of years.

But if the deficit shrinks, so does the growth of liquidity. And so does the reflow of liquidity back to the US. Now that has a range of potential implications.

The first is that it will cause a moderation in demand growth for emerging market goods relative to developed world services. Coming at a time when capacity growth is at its strongest, this will put downwards

pressure on goods prices globally. This tendency is perhaps best expressed in the import price series for the US.

Figure 5 excludes petroleum, but there are some energy prices included. This chart describes, in simple terms, whether there are too many goods in the world (prices negative) or too little (price growth positive), and whether policy is too loose (prices rising) or sufficiently tight (import price inflation falling).

And what Figure 5 signals is that the world moves from inflationary boom to deflationary boom, because liquidity is still growing, but a deflationary boom because the liquidity growth is decelerating.

This suggests a number of key themes.

The first is that pricing power shifts from goods to services, from emerging markets to developed.

The second is that earnings growth shifts from small inefficient companies to big efficient ones. Why? Because in an inflationary boom it pays to be inefficient – because your excess stock generates value (probably more than you do). But in a deflationary boom, excess stock kills you – but strong asset turns at a big efficient producer are a huge benefit.

Then there is self-help and volatility. As the world moves from inflationary boom to deflationary boom, profit share of GDP likely peaks. It gets harder to generate earnings. Raising earnings from 2003-6

DECEMBER 2006 FORECASTS

	Current	End 07 Forecast
UK Policy Rate	5.00	5.25
10yr Gilt	4.55	4.65 - 4.85
10yr ILG	1.5	1.70 - 1.90
FTSE 100	6081	6450 - 6550
A' £ Corporates	69	70 - 80
£/\$	1.97	1.75 - 1.80
€/£	0.67	0.68 - 0.70
S&P 500	1409	1475 - 1525
\$/€	1.33	1.20 - 1.25
¥/\$	115	115 - 120

was, for many corporates, a bit like falling off a log. Topline was rising, capacity utilisation was low (you didn't have to buy new plant to raise output), workers were under-utilised and wages were depressed. But making money from 2007 will be harder. Topline won't be rising as fast, capacity utilisation will be higher and workers will be stretched and demanding higher wages. But it's not the end of the world, because corporates are undergeared. And there is a strong motivation to raise gearing to invest, to buy back shares, or to buy out other corporates and barring a catastrophe, it is hard to see an early end to the M&A boom. For example, for a company with cash on its balance sheet in Europe, earning 3.25% on that cash, it is immediately accretive to buy any

company on a PE of less than 30. As operational gearing shrinks corporates tend to raise financial gearing – to raise their profit exposure to a more moderate expansion of topline growth.

Then there is the rating issue. US PEs have fallen by two thirds since 2002, the year when headline inflation troughed. Since the low, headline inflation more than trebled. But now headline inflation is set to moderate sharply. As Figure 6 shows, that could well lead to a decent re-rating of US earnings. It may not matter that the US is slowing, and that operational gearing is weakening. If US companies raise their financial gearing and lower inflation induces a re-rating of those earnings, then US stocks could perform well.

So, what of the outlook for asset markets?

We make three main calls. We forecast that US and domestic UK equities will outperform emerging markets in a more volatile but rising equity market in 2007. We believe that the dollar will rise. And we forecast that bond yields will rise moderately.

Our key forecasts are set out in the table on the previous page.



Julien Garran
Head of Asset
Allocation

Market Overview

Corporate cash redistribution boosting equity valuations

The US Commerce Department reported another strong quarter for corporate profits in the three months to September. Pre-tax profits were 31% higher than a year ago, standing at nearly 14% of GDP. Net cash flow was also strong, rising by over 12% from a year ago to over \$1.4 trillion.

So what are US corporates doing with all this cash? They have several options. They can invest it. US non-residential investment contributed nearly 50% of economic growth over the third quarter. They can make an acquisition. With nearly 5000 deals announced in the first six months of this year, M&A activity has been a significant driver of market performance. They can pay down debt. Non-financial corporate sector debt has been steadily cut from 55% of market value in the early 90s to around 40% today.

But perhaps the most striking feature of the last two years has been the amount of cash that corporates have returned to

shareholders. Using a combination of buy backs, dividends and buy outs, the US non-financial corporate sector has redistributed nearly \$1 trillion at an annualised rate. In effect, firms are extracting 9% of the value of the equity market each year and handing it back to shareholders.

Comparing this to a cash flow yield of around 4% and a 10-year Treasury yield of 4.5%, US equities look like very good value for money. Indeed, the spread over the Treasury yield has never been higher.

Going forward, these trends are likely to continue. One reason firms have been so keen to reduce the amount of equity assets on their balance sheets is to achieve optimal gearing. The cost of holding equity assets is much higher than the cost of debt, so by gearing up to buy back their equity, firms are able to reduce costs and increase market value. This makes holding equities very attractive.

London

Housing market is key to rates

The UK economy remains in good shape. Growth over the third quarter was balanced across production & services, with household consumption contributing half of the growth over the quarter. Early reports from the monthly retail sales survey suggest spending remained firm in the fourth quarter, although the shorter term trend in retail sales spending has eased. The strength of the economy, and the housing market in particular, prompted the Bank of England to raise rates to 5% in November. The vote was not unanimous, however, with one member suggesting improvements in labour supply had reduced wage inflation pressure. Money markets expect a further hike early next year, which the MPC are likely to deliver if the housing market fails to show any sign of slowing.

Despite a robust economic backdrop, the UK equity market stalled in November after a strong move up in previous months posting a negative total return of 0.3%. Midcaps continued their strong progress however, posting an absolute gain of 3.1% whilst the large cap FTSE 100 index fell by 0.9%. At the sector level Utilities and Transport & Leisure were strong; driven both by corporate activity and strong trading results. At the other extreme Aerospace, Banks and Healthcare were the weakest sectors, the latter continuing to be impacted by poor newsflow on product pipelines as well as the changing political climate in the US. The main corporate event was the bid approach for Scottish Power from Spanish utility company, Iberdrola. J Laing was also the subject of an agreed bid approach. We continue with our generally optimistic view on the market based on attractive profits growth, reasonable valuations and the prospect of further corporate activity.

Wall Street

Market boosted by record deal activity

The pace of growth over the third quarter was revised up to 2.2%, although the reasons for that were not positive for growth – higher inventories and lower imports. This reflects the weakening in demand that the housing market slowdown has generated. There are signs that the worst may be over for the housing market. Sentiment among homebuilders has risen over the past two months and the inventory of unsold homes has eased back. That said, housing is likely to continue to drag on the economy heading into next year. As a result, money markets believe that the Federal Reserve are done tightening. Indeed, they continue to price in rate cuts by the second half of 2007.

Despite some disappointing economic data over the month, the S&P 500 was up 1.65% in local currency terms. The market benefited from benign inflation data and record deal activity as companies and LBO firms put cash to work. Energy stocks rose as winter weather and OPEC production cuts finally grabbed market interest. US mid-term election results impacted the healthcare sector as investors feared increased government oversight. As we head into next year investors will focus on the risks to US GDP growth and the monetary policy response.

Europe

One more ECB interest rate hike priced in

Economic data has been mixed, but sentiment towards the Eurozone economy is still broadly positive, as business confidence remains at elevated levels, the labour market continues to improve and inflation has pulled back. There are some signs of potential weakness going forward, with mortgage lending rolling over and softer export order books. The ECB hiked as expected at the December meeting. Despite revising down their inflation forecasts, ECB President Trichet continued to highlight upside risks to inflation further out, owing to positive growth revisions. Money markets are therefore pricing in a further 25 basis point hike in Quarter 1 next year, but no further hikes thereafter.

Equity market performance was also mixed over November. The DAX rose by 0.7% while the CAC fell by 0.4%, though both outperformed the FTSE 100. Cyclical sectors and some defensives were the better performers over the month, led by Construction and Utilities. The weaker sectors were Steel, Forestry & Paper and Aerospace. Aerospace in particular suffered as a result of the dollar weakness. Looking forward, further dollar weakness is likely to cause ongoing difficulties for European markets. In addition, markets will be looking for any broader signs of economic slowdown in 2007.

Japan

Consumer spending continues to disappoint

Japanese economic data has continued to disappoint. Despite the low unemployment rate consumer spending has remained subdued, although speculation of a strong winter bonus round could well produce some improvement in the coming months. For now, growth remains dependent on exports, contributing to almost all the growth over the third quarter. It is clearly encouraging that Japanese export demand has held up amid the slowdown in US orders, reflecting the importance of intra-regional trade. The key debate is whether the Bank of Japan will raise rates in December. They believe that the underlying economy is strong enough to

withstand a rate hike, and is keen to snuff out what it sees potentially as the start of a real estate bubble. The government, which faces an election in July, is concerned about the impact of premature tightening on growth and argue that Japan has yet to fully shake-off deflation.

The Japanese stock market has underperformed the other major markets in recent months primarily due to unease over the domestic outlook. Companies reported 14% growth in profits during the first half, much better than expected but most failed to revise their full year forecasts which disappointed investors. Until there is clearer visibility on monetary policy and the economic outlook, it is likely to continue to be the more defensive sectors that lead the market.

Pacific Basin

Positive sentiment, but facing headwinds for 2007

In November the FTSE AW Asia Pacific (ex-Japan) Index rose 3.0% in sterling terms. Equity risk appetite remains high which is particularly supportive for the region. China (+10.1%) and Indonesia (+8.3%) led the region, the former benefiting from global asset allocation flows while Indonesia continues to benefit from aggressive interest rate reductions. Australia (+0.4%) was the main laggard held back by resource sector weakness.

While we expect the region to remain buoyant through to the year-end next year remains more problematic given the uncertain impact of a slowing US economy, a weaker US Dollar and a Chinese economy trying to move from investment driven to consumption driven and endeavouring to become more resource efficient. While steady earnings growth is expected next year, valuations already reflect optimism towards the region. However, given corporate balance strength and abundant liquidity, corporate activity can be expected to remain at high levels.

Snapshot

The OECD economic outlook

In the main [Fundamentals](#) article we highlighted that the broad consensus of opinion among economic commentators has shifted to weaker US growth and stronger European growth in 2007. This view is encapsulated in the preliminary version of the OECD's Economic Outlook published in November. The editorial states that "what the world economy may be facing is a rebalancing of growth", with the US and Japanese economies expected to slow relative to Europe. The latest projections, and the changes from the previous Outlook published in May, are shown below.

Projections for the US in 2007 have been revised down sharply, with growth expected to slow to 2.4% next year. The OECD expects the slowdown to be temporary, with growth forecast to move back towards trend in 2008. On this profile, US growth underperforms the UK in both forecast years. The strength of the labour market is highlighted as a particular support for the UK economy, while in the US, unemployment is expected to rise steadily through to 2008. The case for further interest rate hikes in either economy is not thought to be compelling.

In Europe, the OECD expects growth to fall back to 2.2% next year, weighed by fiscal consolidation in Germany and Italy. France by contrast is expected to gradually improve, reflecting the OECD's belief in a sustained recovery in the Eurozone economy. On that basis, they suggest the ECB should continue to raise rates.

The Japanese economy is expected to slow to 2% growth over the coming two years, as the economic recovery translates into sustainable economic growth. In light of the sharp downward revision to their inflation expectations next year, the OECD has stated that the Bank of Japan should be wary of raising interest rates too quickly.

On balance, the OECD is broadly positive on global growth prospects, with non-OECD regions China and India in particular expected to continue to grow strongly, deepening the global rebalancing. This is clearly at odds with our preference for developed world markets in 2007.

GDP GROWTH (% YEAR-ON-YEAR)

	November 2006 Issue			Change from May 2006	
	2006	2007	2008	2006	2007
United States	3.3	2.4	2.7	-0.3	-0.7
United Kingdom	2.6	2.6	2.8	0.2	-0.3
Eurozone	2.6	2.2	2.3	0.4	0.1
Germany	2.6	1.8	2.1	0.8	0.2
France	2.1	2.2	2.3	0.0	0.0
Italy	1.8	1.4	1.6	0.4	0.1
Japan	2.8	2.0	2.0	0.0	-0.2

INFLATION (% YEAR-ON-YEAR)

	November 2006 Issue			Change from May 2006	
	2006	2007	2008	2006	2007
United States	2.9	2.6	2.6	-0.4	0.2
United Kingdom	2.2	2.0	1.9	0.0	0.3
Eurozone	1.8	2.0	2.0	-0.3	0.0
Germany	1.7	1.9	1.0	0.1	-0.2
France	2.0	1.4	1.6	0.3	0.0
Italy	2.2	1.9	2.0	-0.2	-0.2
Japan	-1.0	0.2	0.6	-1.7	-0.6

UNEMPLOYMENT RATE

	November 2006 Issue			Change from May 2006	
	2006	2007	2008	2006	2007
United States	4.6	4.8	5.1	-0.1	0.1
United Kingdom	5.5	5.7	5.7	0.2	0.5
Eurozone	7.9	7.4	7.1	-0.3	-0.5
Germany	8.0	7.7	7.2	-0.5	-0.4
France	9.1	8.5	8.2	-0.4	-0.7
Italy	7.1	6.8	6.5	-0.6	-0.8
Japan	4.2	3.9	3.6	0.2	0.4

Views Commentary

Broadly optimistic outlook for 2008

	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	2.80	2.80	2.60	3.70	1.40	5.10	5.60	5.50	6.00	1.97	1.99	0.68	0.65	7000
Citigroup Smith Barney	-	-	2.60	3.00	5.60	5.80	4.85	4.95	5.25	5.50	1.91	1.92	0.65	0.64	-
CSFB	2.70	2.50	2.70	2.60	7.30	5.40	4.90	-	5.25	-	1.89	-	0.68	-	6600
Deutsche Bank	2.20	-	2.30	-	5.40	-	-	-	5.00	-	1.86	-	0.72	-	6600
Goldman Sachs	2.80	2.70	2.60	2.90	6.50	5.00	4.70	5.10	5.00	5.00	1.87	1.87	0.70	0.72	6850
HSBC Securities	2.00	1.80	1.50	2.50	6.90	5.20	4.30	4.40	4.50	4.00	1.92	1.93	0.75	0.70	6600
JP Morgan	2.50	-	2.60	-	-	-	4.60	-	5.00	-	1.96	-	0.66	-	-
L&G Investment Management	2.70	2.50	2.80	2.80	8.00	8.00	4.75	4.75	5.25	5.25	1.78	1.85	0.69	0.69	6450-6550*
Merrill Lynch	2.70	2.70	2.60	2.70	10.00	6.00	4.55	-	5.00	5.00	1.87	1.73	0.71	0.74	5900
Morgan Stanley	2.40	2.40	2.30	2.50	6.00	6.00	5.30	5.30	5.00	5.00	1.85	1.73	0.67	0.67	6550
UBS	2.60	2.70	2.50	2.80	9.20	4.90	4.65	4.80	5.00	5.00	1.96	1.88	0.68	0.69	-
Median (ex L&G Inv Mgt)	2.60	2.70	2.60	2.65	6.50	5.30	4.70	5.03	5.00	5.00	1.90	1.88	0.68	0.69	6600
Last Month	2.40	-	2.55	-	6.45	-	4.58	-	5.00	-	1.87	-	0.69	-	-
Actual end :															
2005		2.00		1.70		22.7		4.10		4.25		1.72		0.69	5618
2004		2.50		2.90		6.71		4.53		4.75		1.92		0.71	4814
2003		2.60		2.80		10.14		5.05		3.75		1.78		0.70	4476

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 made moderate positive revisions to their forecasts for 2007, with initial expectations for 2008 looking positive also. The economy is expected to expand at around trend over the next two years, with RPI(X) inflation reaching 2.70% in 2008. Gilt yields are expected to rise over the period, although respondents expect earnings growth to moderate from the current pace. Interest rates are expected to remain unchanged at 5% through to the end of 2008. The FTSE 100 is expected to reach 6600 by the end of next year.

In the currency markets, sterling is expected to ease back from current levels against the dollar in 2007, though not by as much as forecast last month, easing further in 2008. Against the euro, sterling is expected to weaken slightly from current levels.

For further comment on Fundamentals, or for additional copies, please contact Lindsey Brooks at lindsey.brooks@lgim.co.uk
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