Fundamentals

Economic and Investment Commentary

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Legal & General

Investment Management

Impounded

Many economic commentators are worried about the UK economy and don't see inflation as a constraint against policy easing. But they might be ignoring the recent collapse in the pound which has fallen the fastest since 1992 on a trade-weighted basis. Given the UK's large current account deficit, it arguably needs to fall more. Sterling weakness will boost inflation directly through higher import prices. It might also boost inflation indirectly through stronger net exports. The Bank of England might therefore want to restrain domestic demand by keeping interest rates relatively high.

Around 30 times more people get struck down by lightening each year than get eaten by a shark, according to SocGen's market psychologist James Montier. Yet most people think the risk of a shark attack is greater because they can visualise it, no doubt thanks to the Jaws movies. Is it the same with the economy? Most economic commentators are worried about the impact of a credit crunch and weaker house prices on the UK economy. But what about the impact of a weaker pound? The largest drop since sterling was ejected from the Exchange Rate Mechanism (ERM) in 1992 has occurred in the last year (Figure 1) and it's barely mentioned. Perhaps because it mainly benefits people working in export sectors like manufacturing and tourism. It is easier to notice a decline in house prices at your local estate agent's window than an upturn in industrial orders at a factory. That's why statistical analysis is useful. Computers don't suffer from psychological flaws like the 'availability' bias described above, they just process hard facts. A variety of econometric models – from Oxford Economics, the National Institute for Economic and Social Research and the OECD (Organisation for Economic Cooperation and Development) suggest that the boost to the UK economy from a

Inside:

THE TRADE-WEIGHTED POUND HAS FALLEN THE MOST SINCE IT LEFT THE E.R.M. IN 1992

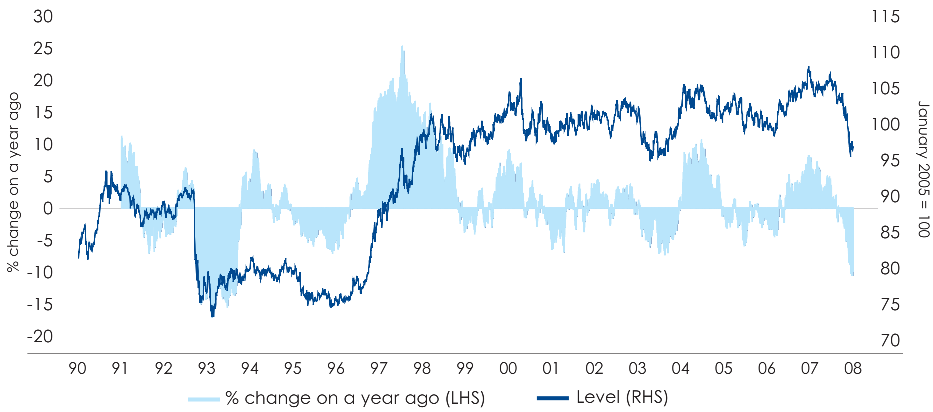


Figure 1

Source: Reuters Ecowin

THE UK HAS THE LARGEST EXTERNAL DEFICIT SINCE 1989

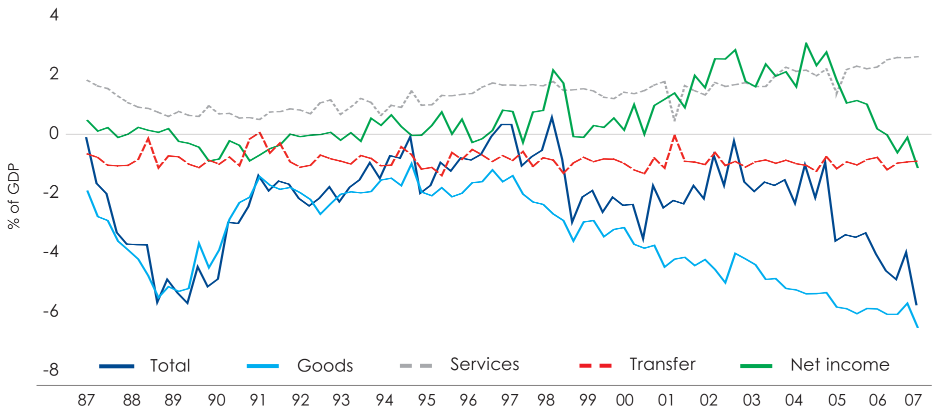


Figure 2

Source: Reuters Ecowin, LGIM

10% fall in the pound is far greater than the drag from a 10% fall in house prices. Presumably the Bank of England's models agree, so it's worth reflecting on how much the pound has fallen, whether more falls are likely and the implications for inflation, growth and financial markets.

Sterling weakness

On a broad trade-weighted basis the pound has fallen by around 10% over the past year. This is the biggest decline since sterling was ejected from the ERM in 1992, when the pound fell 15%. The main decline is against the euro, where it has fallen 15%, it is actually broadly unchanged against the dollar. Given asian currencies are appreciating against the dollar, it has fallen 8% against the Chinese Renminbi and 12% against the Japanese Yen.

The fall in the pound reflects its deteriorating current account deficit (the trade deficit plus net financial transfers). As a share of GDP, borrowing is now as high as it was during the peak of the late 1980s boom (Figure 2) and it is also now the largest in the G7 group of economies (US, UK, Japan, Germany, France, Italy and Canada). A growing goods-trade deficit has consistently offset a stable surplus, but more worrying, there has been deterioration in the net income position. As the UK has run a deficit for such a long period of time, its net asset position has deteriorated, so there is a growing outflow of dividend and bond coupon payments which need to be financed by new borrowing. In a sense, the UK could be entering into a debt trap where its interest payments rise at a faster pace than its ability to service them.

The UK needs inflows to finance its borrowing. There are two natural sources of funds; short-term inflows taking advantage of its higher interest rates and longer-term purchases of UK companies and property. Both factors have recently deteriorated, reducing inflows in the UK, causing a fall in the pound.

Since the pound began to tumble in September, year-ahead interest rate expectations in the UK have fallen from 5.9% to 4.8%, a decline of 1.1%. By contrast, euro-area rate expectations have only fallen from 4.2% to 3.7%, a decline of 0.5%. This might reflect the perception that UK economic growth is more vulnerable to a financial crisis, reflecting the importance of its housing market and its financial services industry as opposed to the euro-area's strong export exposure to emerging markets. Moreover, the European Central Bank (ECB) is seen as more 'hawkish' and more determined than the Bank of England to keep interest rates high in the wake of soaring food and energy prices. These perceptions have been justified, the Bank of England did indeed cut interest rates in December while the ECB has maintained a tightening bias.

Moreover, financial market turbulence has reduced merger and acquisition (M&A) activity. The number of M&A deals involving UK firms plunged by 35% year-on-year in December, according to Citigroup. Given the UK market is more open to inward investment than many European markets, the collapse in M&A activity might have depressed a natural source of demand for pounds to finance its deficit.

Has the pound fallen enough?

Now that the pound has started to fall, the obvious question to ask is how much further does it need to go? There are various ways to measure fair value for the pound. The simplest is to compare relative price levels (purchasing power parity (PPP)). If the price of a product is cheaper in one country than elsewhere then its currency needs to appreciate until prices are equalised. Otherwise people will buy

UK CONSUMER PRICES ARE IN LINE WITH THOSE OF ITS TRADING PARTNERS

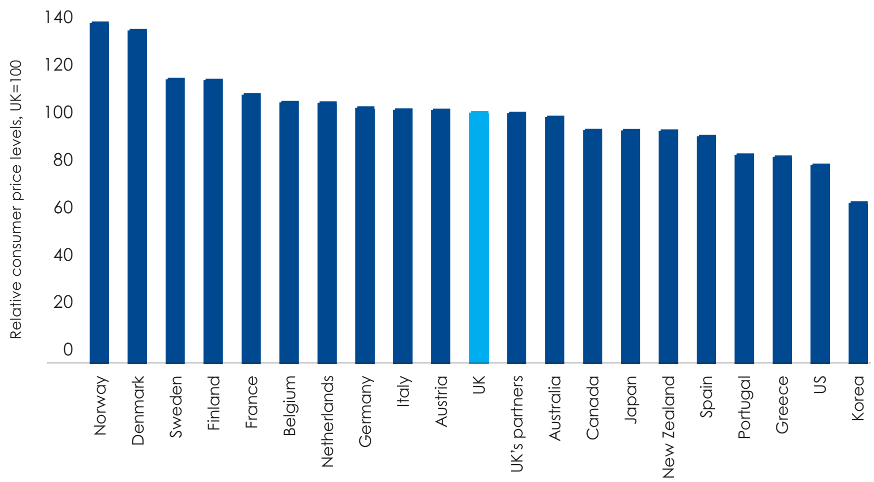


Figure 3

Source: OECD, Bank of England, LGIM

UK WAGES ADJUSTED FOR PRODUCTIVITY ARE SIGNIFICANTLY ABOVE THOSE OF ITS TRADING PARTNERS

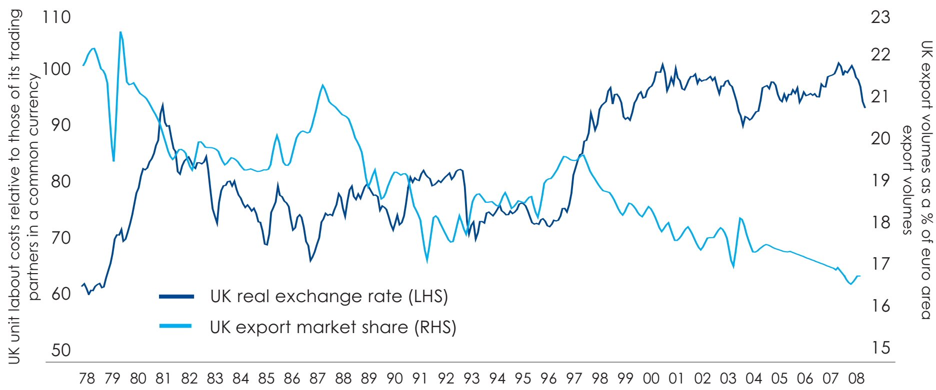


Figure 4 Source: Reuters Ecowin, LGIM

the goods from the cheaper country, bidding up demand and its currency until prices are equalised. The most popular example of PPP is The Economist newspaper's 'Big Mac' index, which compares the price of a McDonalds burger around the world. This suggests the pound is slightly cheap on a trade-weighted basis. Undervalued against the euro but overvalued against the dollar.

A broader measure of PPP using all consumer prices is published by the OECD. This suggests the pound is fairly valued (Figure 3). But in our view, there are flaws with looking at consumer prices as a measure of fair value for a currency. They might reflect the openness and competitiveness of a country's retail sector rather than its export sector and therefore its ability to solve its deficit problem. For example, import penetration of Chinese clothing and footwear is much larger in the UK than in most of the euro area. This partly reflects the strength of the pound in the late 1990s, which led to a surge in cheaper imports, but it also reflects the competitiveness of the retail sector and their ability to discount items. It tells us little about the ability of UK manufacturers to gain market share either at home or abroad.

To measure export competitiveness we can look at estimates of wages adjusted for productivity and currency movements (relative unit labour costs). The IMF estimates that UK relative unit labour costs were still almost 25% above the average before the Bank of England was made independent in 1997. This explains the UK's loss of market share and why it has such a large trade deficit. So arguably the pound has much further to fall (Figure 4).

Inflation threat

The pound therefore seems set for a structural long-term decline, particularly against asian currencies, whose economies enjoy large surpluses. But in the near term, the pound could stabilise if the Bank of England refuses to cut interest rates as much as the market expects. The reason for that is that a weaker pound has significant implications for inflation – both directly through import prices and indirectly through stronger growth.

Based on the fall in the pound and the strength of the global economy, our model suggests UK import prices (excluding oil) will rise by 7% in 2008, the strongest increase since 1995. This compares with an average decline of 1% per year since the Bank of England was made independent in 1997, which will pose a serious policy dilemma for the Bank (Figure 5).

Our inflation momentum model which calculates the probability that core inflation (ex food and energy) will rise suggests inflation would keep rising until the end of 2009 unless the economy contracts by over 1% in 2008 (Figure 6). By contrast, the Bank of England assumed in its November Inflation Report that inflation will peak in mid 2008 and ease back towards target in 2009. Sustained increases in inflation could cause concern at the Bank of England given it is already worried by elevated household inflation expectations.

Growth boost

Of course, if the UK were to contract by 1% in 2008, the inflation picture should improve over the medium term. But it's unclear to us whether the UK economy is going to deteriorate that much as a weaker pound should actually boost economic activity through stronger exports.

Model simulations using Oxford Economic Forecasting suggest a 10% fall in the pound boosts growth by around 0.75% per year. With inflation also rising by 0.75% per year, this results in over 200bp of rate hikes. By contrast, a 10% fall in house prices is only estimated to knock 0.25% of GDP growth

UK IMPORT PRICES ARE SET TO RISE SIGNIFICANTLY IN 2008

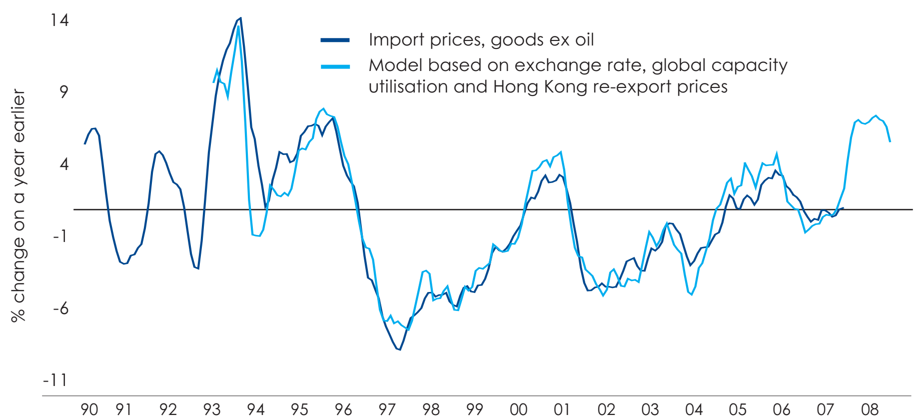


Figure 5 Source: Reuters Ecowin, LGIM

per year, resulting in 50bp of rate cuts (Figure 7). So a 10% fall in the pound is estimated to be three times more powerful than a 10% fall in house prices. Of course, these estimates should be treated with caution. In particular, it might take time for an economy to rebalance away from consumption towards exports, leading to a prolonged period of below-trend growth. But a boost to growth from net trade is an important factor the Bank of England will consider when assessing the economic outlook.

INFLATION IS LIKELY TO KEEP RISING UNTIL THE END OF 2009

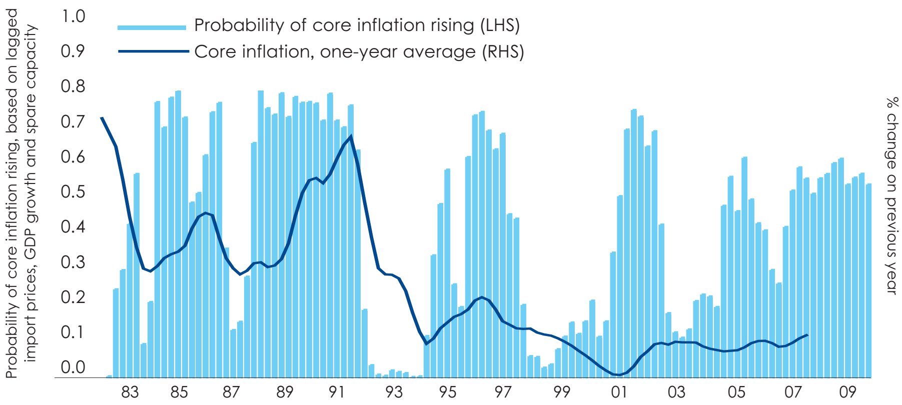


Figure 6 Source: Reuters Ecowin, LGIM

The main way in which a weaker pound boosts the economy is through stronger exports. The consumer is squeezed by higher import prices but benefits from a stronger labour market and falling unemployment. Ultimately consumer demand suffers from higher interest rates as policy makers tighten policy to combat inflation.

So ordinarily, a fall in the pound should lead to the Bank of England raising interest rates. But in reality, policy has already been tightened. For example, we estimate that the spread between fixed mortgage rates and 2-year swap rates has increased by 60bp since last summer. We've also seen a widening in the spread between corporate and government bond yields.

Moreover, there has been a deterioration in the global economy, particularly in the US. But in contrast to 2000/01, global manufacturing confidence has stabilised in recent months. In particular, euro-area capacity utilisation rates remain elevated, supporting business investment. This is crucial as the UK exports a disproportionate amount of capital goods to the euro area. This is why UK exports suffered so much between 2001 and 2003 – it was a global capex slump. But at present we are in a global capex boom. In particular, emerging markets like China, India and South Africa have severe infrastructure needs, with all economies reporting power shortages recently. So the Bank of England should continue to cut interest rates, but perhaps not as quickly as many people are hoping.

Outlook

The continued difficulties in financial markets pose significant downside risks to the global economy, but it's unclear whether those risks have fully materialised yet. The latest ECB bank lending survey showed a collapse in demand for loans for financial engineering (such as mergers and acquisitions) but only a modest slowing in real engineering loans (for example machinery and equipment). Moreover, the CBI (Confederation of British Industry) recently stated that "despite the ongoing credit squeeze, manufacturing firms do not report that access to or cost of external finance is a factor likely to limit either output or investment expenditure".

So our central case remains that the economy is set to rebalance away from housing and consumption towards manufacturing and exports. This should entail a painful adjustment period of below-trend growth. But with global and domestic measures of capacity utilisation above normal, this is necessary to ease inflation pressures.

To limit the inflationary consequences of the recent fall in the pound, the Bank of England is therefore likely to cut interest rates slower than financial markets expect. This could provide a setback for equities, particularly smaller domestic plays and financials. But larger companies who derive a greater share of their earnings from the global economy should hold up better as a weaker pound boosts earnings. Of course, the Bank of England could instead choose to cut interest rates aggressively in response to signs of weaker economic growth. But given the UK's large current account deficit, this should entail further weakness in the pound, boosting inflation pressure and eventually long-term interest rates.

A 10% FALL IN THE POUND HAS A MORE POWERFUL EFFECT THAN A 10% FALL IN HOUSE PRICES

	10% fall in the pound			10% fall in house prices		
	GDP growth %	Inflation %	Interest rates %	GDP growth %	Inflation %	Interest rates %
2008	0.7	0.7	0.8	-0.2	-0.6	-0.2
2009	1.0	0.7	2.3	-0.2	-0.2	-0.5
2010	0.3	1.2	3.0	0.6	-0.3	-0.1

Figure 7 Source: Oxford Economics, LGIM

Market Overview

Fed slashes rates to calm markets

Recent economic data have been weaker than we expected in the US but broadly in line in the rest of the world. Official data suggest US employment fell in January for the first time since 2003 and the decline in business services confidence was quicker than recorded following 9/11 and the Iraq War. But German business confidence unexpectedly rose in January and the UK economy grew by 0.6% quarter on quarter in Q4 '07, above market expectations. The consensus appears to expect the weakness in the US to spill over into the rest of the world with a lag. This is clearly a downside risk to our more benign forecast. But some of the weakness in US data could be erratic, reflecting the sudden collapse in the stockmarket. To stem the weakness in the economy and financial markets the Federal Reserve cut interest rates by 125bp in January and the Bush administration is making progress towards cutting taxes.

London

Probably the best takeover in the world

The UK equity market fell 8.7% in January, suffering from increased fears of a recession in the US. There was little to choose between the performance of large, mid and small cap stocks. Real Estate was the only sector to post a positive return as the sector bounced back from a very weak end to 2007 and the market looked forward to the prospect of interest rate cuts. General retailers, however, remained subdued after weak retail sales data and downbeat trading statements from retailers such as Next and Debenhams. Corporate activity saw Scottish & Newcastle finally agree terms for a takeover by Carlsberg and Heineken whilst Xstrata confirmed it had received a takeover approach from Brazilian mining company, Vale. We expect markets to remain volatile in the short term with increased evidence of slowing consumer spending and difficult credit markets impacting on corporate profits.

Wall Street

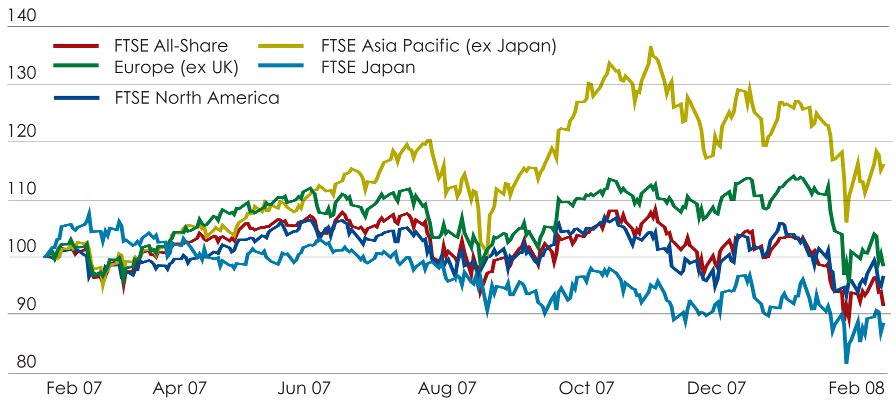
Short squeeze at the banks

The S&P 500 clawed back to a negative -6.0% return in January after being down as much as 10.8%. Before the market opened on the 22nd, the Federal Reserve (FED) stepped up its rate cut campaign with an inter-meeting 75 bps cut to rates. This more aggressive action was a catalyst for a short squeeze in the market, with Banks, Diversified Financials, and Retail leading the rally.

The S&P 500 Q4 '07 earnings growth rate currently stands at a negative -20.6%. To date, 52% of the companies within the S&P 500 have reported Q4 '07 earnings. Excluding financials, S&P 500 companies continue to post double-digit earnings growth rates with a Q4 '07 estimated growth rate of 13.0%.

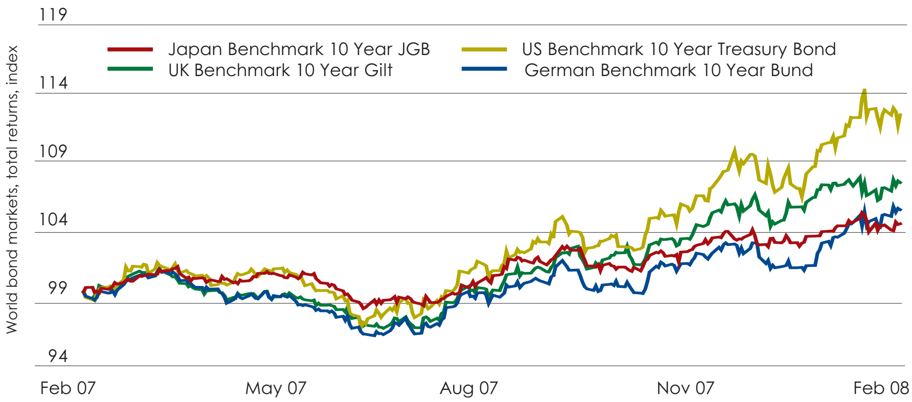
The outlook for the equity market remains challenging. Profits estimates for 2008 are likely to be reduced, as write downs from the financial sector continue and the more restricted availability of credit and ongoing correction in the housing market dampen the growth outlook. Equity valuations remain supportive however and corporations continue to buy back stock. These factors should continue to provide downside support, as the excesses of the housing boom continue to unwind.

MAJOR EQUITY MARKETS – TOTAL RETURNS £ 2006/2007



Source: Datastream

MAJOR WORLD BOND MARKETS – TOTAL RETURNS £ 2006/2007



Source: Datastream

Europe

Le rogue trader

Hopes that 2008 would start on a positive note were dashed, as the European markets joined other markets around the world and registered sharp and unrelenting falls over the course of the month. The cut in US interest rates did little to assuage concerns that the rest of the world will follow should the US economy slip into recession. In Europe, monetary policymakers were eager to point out that they would not necessarily be following the Fed with such alacrity, as European growth still remains comparatively healthy and there are incipient inflationary pressures. The impact of this combination of intransigence and investor fear saw a widespread fall in equity values, exacerbated by the forced selling that Société Générale was obliged to carry out to unwind transactions instigated by a 'rogue trader'.

Looking ahead, there is little doubt that equities around Europe would appear to be cheap on the basis of conventional indicators, provided expectations for earnings can be trusted. Herein lies the dilemma for investors: until it is clearer which direction the global economy and interest rates will take, and the full extent of banking sector write-offs is clear, there is little prospect of a meaningful and sustainable rally in markets, driven by earnings expectations which are untrustworthy. In Europe in particular, certain parts of the market have been oversold and certainly offer long-term value, but in the current environment such value may not be appreciated in the near term.

Japan

Japanese eyes watching the world

January was the most turbulent month for the Japanese stock market in history, with the Nikkei ending the month down -11.2%. A spate of negative economic data in the US, the announcement of a huge trading loss at Société Générale and further write downs by financial institutions caught up in the credit crunch, contrived to push the Japanese market lower. Shares were sold off indiscriminately with the banking sector and exporters leading the declines amidst volatile trading.

After Fitch downgraded a large monoline insurer in January, the market is bracing itself for the re-rating of similar companies, which would have serious connotations for the credit market. Spectators are closely watching US data for any signal that economic weakness has spread to domestic consumption. Investors are also weighing up the prospect of a fiscal measure employed by the US in response to recession fears. In Japan, the third quarter earnings season is about to begin and close scrutiny will be applied to the new forecasts of companies with a December year end. At current valuations Japanese equities are very attractive versus the other global markets.

Pacific Basin

High commodity prices contain markets

The FTSE All World Asia Pacific (ex Japan) Index fell by 12.2%, in sterling terms, in January as fears grew of a US recession and its potential negative impact on the world economy and Asia in particular.

Although US interest rates were slashed, outside Hong Kong only the Philippines has cut interest rates this month and then only by 0.25%. It is apparent that the Asian central banks have preferred to focus on reducing inflation expectations for the moment, having confidence in the strength of their domestic economies.

In Taiwan there was a resounding victory for the KMT party in the legislative elections. The margin of victory suggests that the party has a strong chance of winning the more important presidential election in March, which could prove to be a defining moment for the country's future relationship with mainland China.

In the short-term investors' concerns about the impact of a deeper downturn in the US economy, the prospect of downgrades to Chinese growth, due to the weather and infrastructure constraints, combined with the potential inflationary impact of high energy and food prices may continue to constrain markets.

Snapshot

US banks restricting credit

Once a quarter, the Federal Reserve conducts a survey of domestic and foreign banks, asking them about the availability of and the demand for credit. The survey covers loans to households for mortgages and consumer durables such as cars as well as credit cards. It also looks at lending to corporates for general use as well as for commercial property.

The latest survey showed a further tightening in lending conditions for commercial and residential property, with both series showing the most difficult environment ever. Lending conditions for consumer durables also continued to worsen, hitting the worst since 2001. For corporates, standards deteriorated to the worst since mid 2000.

We have created a composite series based on the contribution of the different parts of the economy to growth. This is based on their size and variation. Different economic cycles have different drivers. For example, the 2001 recession was driven by corporate capex. The current downturn is driven by housing and should be followed by commercial property.

We haven't included consumer credit cards in our analysis (which ironically are holding up better than the other series), as the data only goes back to 1995 and we want to get two full economic cycles. Our analysis suggests overall credit conditions based on their contribution to growth are worse now than in 1991 (Figure 1).

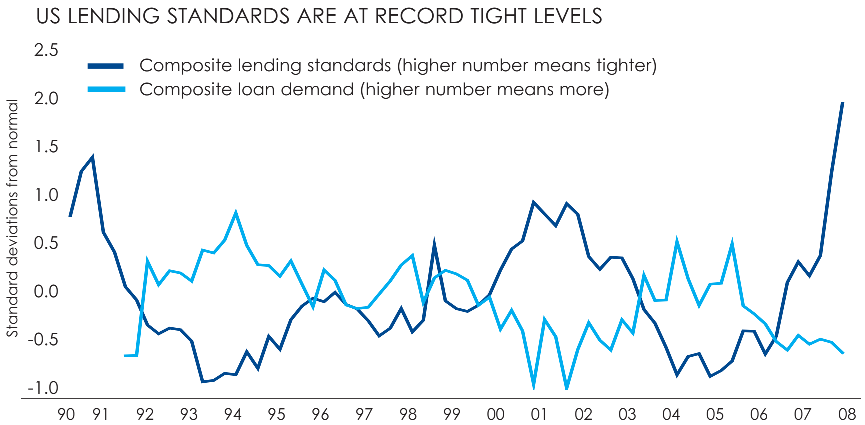


Figure 1 Source: Reuters EcoWin, LGIM estimates

This is important because risk-free government bond yields have come down following the aggressive policy easing by the Federal Reserve. This has been reflected by a sharp decline in prime 30-year mortgages too. But what we don't know is how easy it is to get a new loan or refinance an existing one at these more attractive levels. The Senior Loan Officer survey suggests the economy might not be fully benefiting from lower interest rates.

We have estimated the impact of lending standards on economic activity using not only composite lending conditions, but also a weighted index of recorded demand for loans. We find the Senior Loan Officer survey is a good predictor of the contribution to economic growth from interest-rate sensitive sectors of the economy such as homebuilding, consumer durable purchases and business investment. The latest survey results should knock 0.5% off GDP growth in 2008 (Figure 2). This explains the rush by politicians to cut taxes to provide an alternative stimulus to the economy.

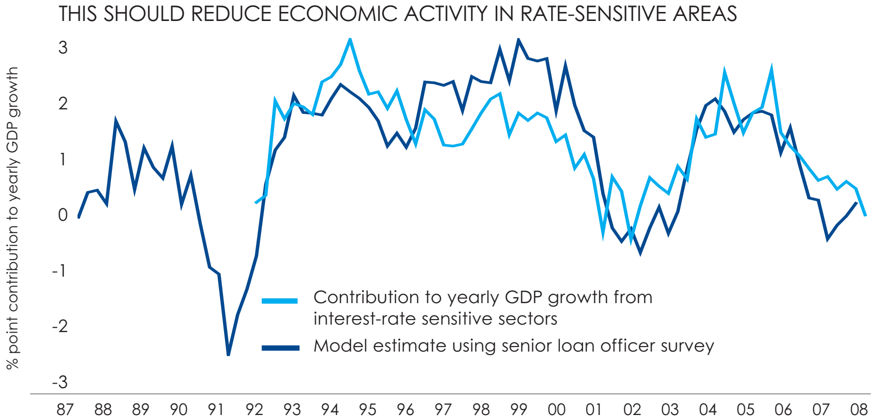


Figure 2 Source: Reuters EcoWin, LGIM estimates

Views Commentary

Inflation rising as rates falling

	Price Inflation (HICP) End 2008 %	End 2009 %	GDP (Growth) End 2008 %	End 2009 %	Earnings (Growth) End 2008 %	End 2009 %	10 Yr Gilt Yields End 2008 %	End 2009 %	Base Rates End 2008 %	End 2009 %	$/£ End 2008	End 2009	£/Euro End 2008	End 2009	FTSE 100 End 2008
ABN Amro	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Citigroup Smith Barney	-	-	1.70	2.00	8.40	7.70	4.65	-	4.25	-	1.92	-	0.75	-	7000
CSFB	2.40	1.60	1.40	2.60	1.00	-	4.60	-	4.75	4.75	1.84	-	0.74	-	6800
Deutsche Bank	2.10	1.80	1.80	2.10	8.30	8.40	4.70	-	5.00	-	1.93	-	0.75	-	7200
Goldman Sachs	2.50	2.20	1.20	2.70	4.70	12.60	4.50	4.70	4.50	4.50	1.97	1.85	0.72	0.72	-
HSBC Securities	1.80	2.00	1.00	2.40	10.00	5.00	4.50	4.50	4.50	4.50	1.79	1.73	0.75	0.75	7100
JP Morgan	2.60	2.10	1.80	2.80	-	-	-	-	4.75	5.00	-	-	-	-	-
L&G Investment Management	2.40	-	1.80	-	4.00	-	4.75	-	5.00	-	2.00	-	0.75	-	6250
Merrill Lynch	2.50	2.00	2.10	2.20	4.00	6.00	4.50	-	5.00	5.00	1.95	1.68	0.76	0.76	6500
Morgan Stanley	-	-	1.80	2.20	-	6.00	5.30	5.30	5.25	5.25	1.86	1.83	0.71	0.69	6300
UBS	2.20	1.60	1.50	1.70	6.30	10.60	4.40	4.60	4.25	4.25	1.99	1.90	0.73	0.70	6500
Median (ex L&G Inv Mgt)	2.40	2.00	1.70	2.20	5.50	7.70	4.55	4.65	4.75	4.75	1.93	1.83	0.75	0.72	6800
Last Month	2.20	2.05	3.10	1.85	5.25	7.50	4.77	4.68	5.75	5.00	2.06	1.96	0.71	0.72	7200
Actual end : 2007	2.10		2.90		6.20		4.51		5.50		1.98		0.75		6453
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

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 2008, not a point forecast.

Respondents to our survey this month have lowered their 2008 base rate forecast again for the third month in a row, expecting the Bank of England to lower rates to 4.75%. Following February's decision to cut rates by 25bp, another two cuts are now expected this year.

With continued cuts in the base rate expected sterling strength has been eroded over the last few months and this is reflected in further downside revisions to sterling forecasts against the euro and dollar.

Once again Gilt yield estimates have also been revised down as the bond markets continue to be affected by credit concerns. These credit worries are also now affecting earnings growth as further downward revisions have been made to 2008 numbers though earnings are expected to pick up in 2009.

Inflation forecasts have again been raised as gains in food and energy do not seem to be ending.

Across the board FTSE 100 estimates have been slashed as weaker economic growth and stubborn inflation are expected to make it difficult for equity markets to reach new highs.

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