

## The long road back

Last spring, our lead indicator began to flash ‘recession alert’ for the UK economy. Since then, we have remained far more pessimistic about the outlook for UK economic growth than other economists (Figure 1). But as the global backdrop has deteriorated, that gap has now closed. We now find ourselves slightly more optimistic than consensus about the prospects for the UK economy. Our lead indicator envisages a gradual recovery beginning later this year. Lower energy prices, falling mortgage rates and a slight easing in credit availability should boost growth as we head into 2010. While risks remain, particularly from a sharp rise in the household savings ratio or falling wages, our lead indicator suggests that early 2009 probably marked the most intense phase of the contraction, though recession is likely to linger for a few more months.

Our UK lead indicator suggests year-over-year GDP growth should improve by 5½ percentage points by the end of 2010 (from a low of -3½% in Q309 to just under 2% a year later). This is shown in Figure 2 which plots our UK lead indicator against actual GDP growth as well as our central forecast for 2009 and 2010. Our lead indicator is designed to predict year-over-year GDP growth in a year’s time. The dotted part

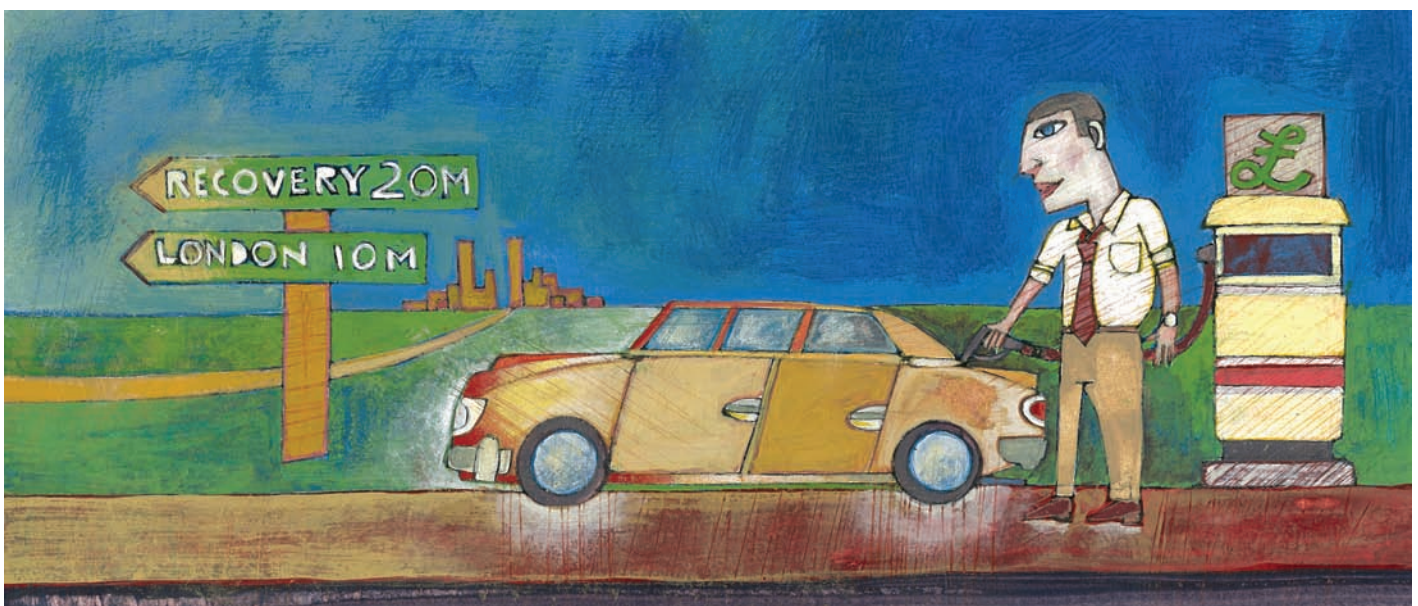
represents the period where we have had to estimate the variables that drive our lead indicator; such as mortgage rates, energy prices, exchange rates, debt and external demand.

So, what is driving the 5½ percentage point improvement in our lead indicator? The catalysts can be divided into approximately four equal components. These are: falling

mortgage rates, a combination of lower energy prices and a weaker pound, improvements in household balance sheets and finally, an expected recovery in the global economy.

### Lower mortgage rates

Lower mortgage rates for existing homeowners are one of the main factors pushing up our lead indicator – boosting



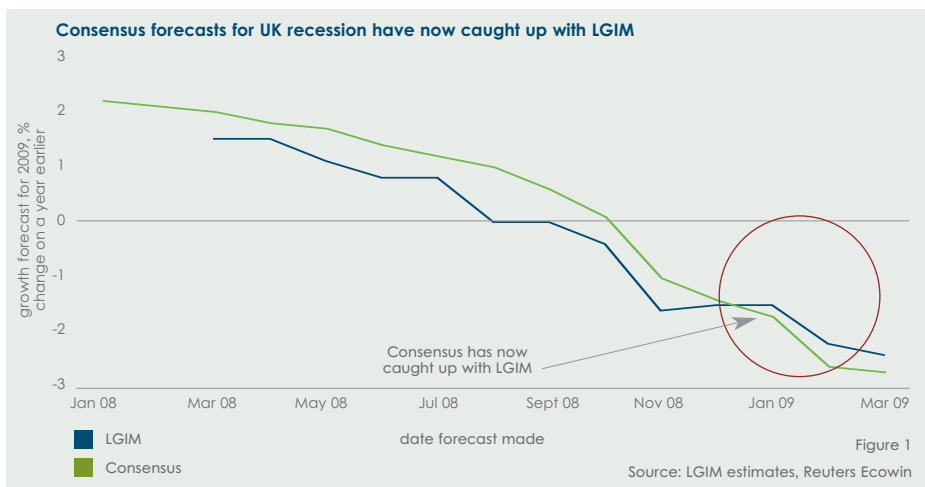
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growth by around 1½ percentage points over the next year. It is true that interest rates for new homebuyers with small deposits remain high, suggesting housing transactions will remain weak. But for existing homeowners, debt servicing costs have fallen dramatically in recent months as the Bank of England has slashed its base rate to just ½%. The effective mortgage rate paid has fallen by 1½% between October and January. It could fall another ½% by the end of the year, reflecting further policy easing that took place in February and March but is not yet reflected in the data. Lower interest payments will improve the cashflow position of indebted households, making it easier to maintain consumer spending.

We believe the UK has a significant advantage here compared with other countries, as UK fixed-rate mortgage deals typically expire after 2-3 years. UK consumers' mortgages then automatically switch onto their lender's standard variable rate. As standard variable rates for existing customers have fallen sharply in recent months in tandem with the Bank of England's base rate, households will benefit from lower interest payments when their fixed-rate deal expires.

The situation is quite different in the US, however, where most mortgages are fixed for 30-years. It is expensive and difficult for households to refinance as they typically cannot borrow more than 80% of the value of their home to qualify for a cheap

'prime' mortgage. Sub-prime mortgages are far more expensive. Given US house prices have fallen by almost 30% since their peak in 2006, many homeowners are unable to refinance to a prime mortgage because they don't have enough equity in their home. To resolve this, the US administration is trying to make it easier for distressed borrowers to refinance and also push down long-term mortgage rates. It remains to be seen how effective these measures will be. But in the meantime, UK households have already benefited from lower mortgage payments, suggesting UK consumers are in a more fortunate position than their US counterparts.

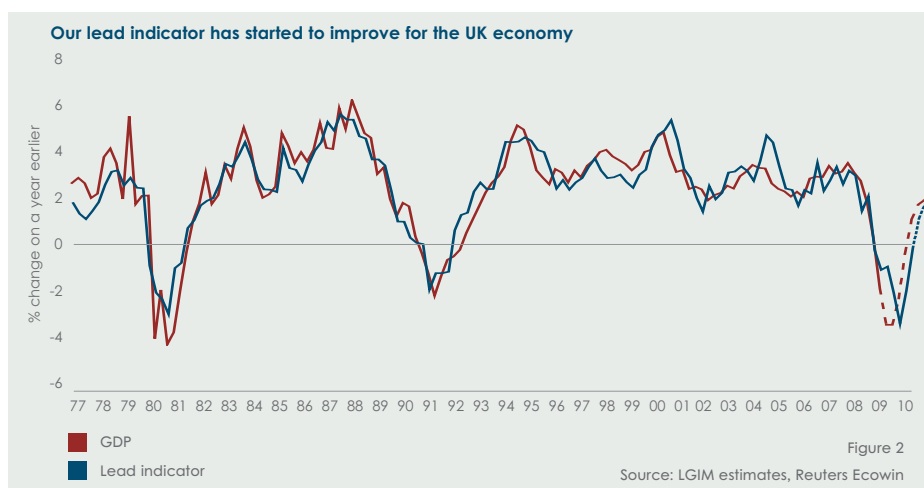
### Lower energy prices

Lower energy prices should also boost UK consumers' cash flow. At around \$40-50 per barrel, oil prices are currently some two thirds less than the peak recorded last June. This boosts our lead indicator by ¾

percentage point. Petrol prices have already fallen sharply and gas and electricity bills are expected to fall in the spring which will boost consumers' spending power. High energy prices were also a significant burden for the corporate sector in 2008, reducing profit margins. This put pressure on companies to cut other costs, such as labour. Lower energy prices should therefore provide a welcome relief for the corporate sector too.

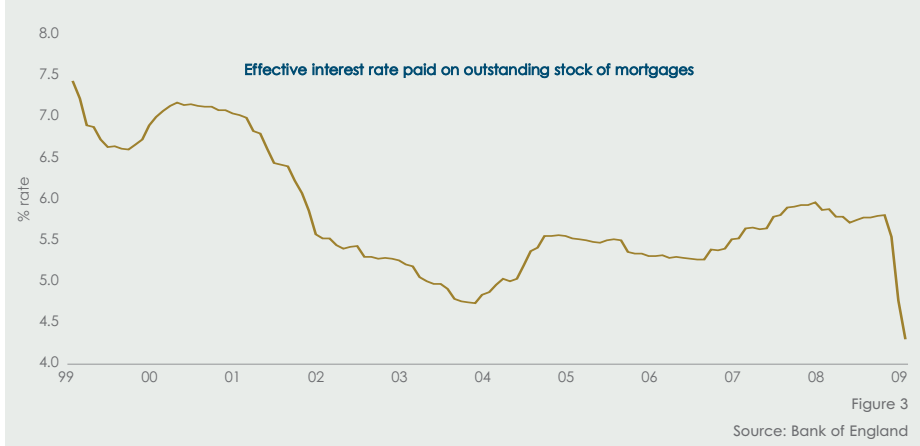
### Weaker pound

The sharp fall in the pound also boosts our lead indicator by ¾ percentage point as UK firms gain market share (Figure 4). Somewhat ironically, the sharp slump in global output could make it more likely this will happen. If the global economy were still robust and capacity utilisation rates were high, firms would be unable to boost output in the short-term. Instead, they would just respond to a weaker pound by boosting prices, keeping them unchanged in foreign currency terms. Only after a long lag could new capacity be introduced and skilled workers trained and hired. But the global economic slump has seen manufacturing utilisation rates fall well below average. When the global economy recovers, multinationals are likely to boost production in their UK plants first, given the cost advantage from the weaker pound. This should have a positive knock-on effect for local suppliers and consumer spending could benefit from any improvement in job security.



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## UK consumers are paying significantly less interest than before



## Debt

Our lead indicator is also affected by the amount of debt in the economy. At present, both public and private sector borrowing is high, implying there is little room to increase spending further. This helps explain why durable goods such as car sales have fallen so much over the past year. Consumers have already taken on lots of debt to buy such goods and now need to repay those debts. But over time, balance sheets should improve as households save more. This should create some pent-up demand to replace worn-out durable goods, contributing one percentage point to the improvement in our lead indicator.

## Foreign demand

The remainder of the improvement in our lead indicator (1½ percentage points) is driven by an expected improvement in the global economy. Policy easing and lower energy prices should boost growth in the UK's trading partners over the following year. We've already seen some improvement in emerging economies, with Chinese and Brazilian car sales recovering after sharp falls in Q408. It's worth remembering nearly half of the world's central banks were raising interest rates last summer to combat inflation. They were deliberately trying to restrict consumer spending and investment. The collapse in credit markets following the bankruptcy of Lehman Brothers made things significantly worse. But policy in emerging economies has now been

loosened aggressively. In China, loan growth has reaccelerated, suggesting policy easing there is working. Moreover we've also seen the first signs of improvement in US credit availability (Figure 5).

## Show me the money

Since 1967, senior loan officers at US banks have been asked how easy it is for a consumer or business to get a new loan (the SLO survey). In Q408, the availability of credit was the worst ever in the 41-year history of the survey. But things improved somewhat in Q109, particularly for consumer loans. This probably reflects government intervention. In return for injecting new capital, banks and finance companies have promised to increase lending. For example, GMAC – the financial services arm of General Motors – recently announced that it would extend loans to consumers with worse credit

scores than before, following a \$6bn bailout. While conditions are still 'tight', they are slightly better than before which could imply key economic indicators, such as car sales or home sales, are close to bottoming out at record low levels.

## Car Inventories

Given US production of both cars and new homes are now running below sales, a stabilisation in demand (even at low levels) would be positive for the economy. For example, US car sales have collapsed by 40% over the past year, causing a sharp rise in unsold inventories (Figure 6). But production is now down 60%. So if sales stabilise, inventories will be run down and eventually production can increase back in line with sales.

Similarly, if US new home sales were to stabilise, unsold inventories would fall sharply and this should limit downward pressure on house prices. Were this to happen, we could have a self-reinforcing economic recovery. Stable house prices would allow banks to quantify their losses. Combined with government cash injections, more funds might then be made available for lending, which in turn could support car and home sales and so on.

It is therefore possible that the modest improvement in lending conditions in Q109 is the first step towards a gradual self-reinforcing economic recovery. With governments taking even more radical

## The recent fall in the pound and energy prices should support growth



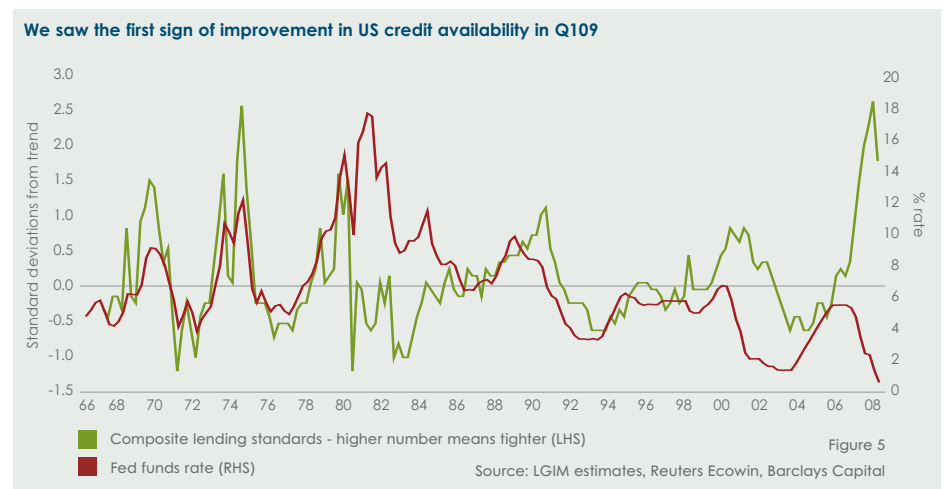
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action to boost the economy (including printing new money to buy private sector debt) economic conditions should stabilise later this year. By contrast, consensus and financial markets appear to be more pessimistic than they were before. This doesn't imply that risk markets are cheap as consensus expectations were more optimistic than us and needed to fall back. But it does suggest markets have become more attractively priced.

### Risks and relative performance

Recent data have confirmed the negative signal given last spring from our lead indicator that a global recession would intensify around the turn of the year. While global manufacturing confidence has improved somewhat in recent months, it remains consistent with sharp contractions in output. There is danger that policymakers fail to break the negative feedback loop between rising unemployment and falling asset prices which in turn causes a dramatic change in consumer psychology. Household saving ratios have been dangerously low in both the US and UK for some time. It is possible that households have decided to rebuild saving quickly. In doing so, we could still be stuck in a self-reinforcing downturn as weaker consumer spending means more unsold inventories, job losses, wage cuts and bad debts. So we cannot rule out the global economy continuing to contract in 2010, despite the improvement in our lead indicator. But on a relative basis, the UK could be one of the better performers globally given the greater flexibility of mortgage rates and the increased competitive advantage of the weaker pound.

By contrast, consensus expects the UK economy to significantly underperform the US in 2010. It expects the US economy to grow by 2% in 2010, but the UK to grow by just ½%. We expect both economies to grow by around 1½%. If we're too optimistic on global credit creation or household behaviour, both economies could grow by less. But the difference between both economies is likely to be



small, in contrast to the wide gap that consensus expects. While growth expectations in the UK are likely to improve from here, those for the US are likely to deteriorate, undermining the potential positive implications for risk markets.

Another potential disappointment for financial markets comes from the composition of the recovery in UK growth. We're not more optimistic than consensus on consumer spending and we're actually more pessimistic than consensus on business spending on equipment. Instead, we see a sharper turnaround in manufacturing stockbuilding than consensus. As discussed earlier, manufacturers are currently slashing output to run down unsold stocks of finished goods such as cars. For example, Honda recently announced it was closing down its Swindon factory for four months. We suspect this destocking process will reduce

UK GDP growth by 1½ percentage points in 2009. But as production resumes (even if not at full capacity), this should boost growth by ¾ percentage point in 2010. Unfortunately, just as destocking only has a temporary negative effect on growth, restocking will only provide a temporary boost.

An improvement in manufacturing activity indicators (such as monthly business confidence readings) is likely to be taken positively by risk markets in coming months. This could cause growth expectations to be revised up. But if we're right that the improvement in activity comes from restocking rather than final demand (such as consumer spending or investment) then we could see a renewed setback in market confidence later in the year. For this reason we still see equity markets in a trading range rather than the asset class of choice over the next year.



## Market Overview

It now appears likely that world growth during 2009 will be the weakest since World War II. Recent economic data throughout both developed and emerging economies paints a picture of a sharp and widespread recession. Global trade and industrial production collapsed late last year and inventories of stocks have been piling up as people have reined back their spending. Surveys of business activity and consumer sentiment are at depressed levels, unemployment is rising and headline inflation is likely to continue falling sharply, even turning negative through many countries.

As a result, governments and monetary authorities across the globe have responded in force. Official interest rates have been slashed, and as they head towards zero in many countries, it is likely that unorthodox measures will continue to be rolled out. Quantitative easing (essentially printing money) is already underway in the US, UK and the European Central Bank (ECB) appears likely to follow suit.

We believe that growth will begin to recover later this year and that the economic recovery will be synchronised across US, UK and Europe. However, while growth will be aligned, equity market performance remains a function of how significantly the cyclical downturn has already been priced in.

## Equity Overview

### UK

#### Buying up banks

As economic growth slows and unemployment rises, people have reined back their spending and company profits remain under significant pressure. It seems likely that UK unemployment will spike to as high as 9% this year as companies dramatically cut costs.

There are also fears that widespread wage freezes could cause inflation to fall below the Bank of England's (BOE) target in the medium term. Given how high personal debt levels are, the BOE is very worried about inflation falling too low. It recently announced plans to buy gilts and corporate bonds with newly created money causing a sharp rally in gilts.

As the market (tracked by the FTSE All-Share Index) declined over 7% during February, the banking sector again took up most of the attention. Of most interest were developments regarding the government injecting further funds into the Royal Bank of Scotland (RBS) and the possibility that the government may actually move to nationalise the entire UK financial system.

### US

#### Policy innovation

The US equity market (as measured by the FTSE All-World North America total return index in sterling) declined around 9% during February. With official interest rates sitting at essentially 0%, the Fed has had to take innovative steps to help households and businesses obtain loans again. There used to be a close link between the level of lending and official interest rates. As lending conditions have deteriorated, this relationship has completely broken down.

In addition to their traditional role of providing short-term liquidity to financial institutions, the Fed has also developed the tools to provide liquidity to borrowers and investors in key credit markets directly and is purchasing longer-term securities.

The extent of the recent fiscal and monetary stimulus efforts should start having an effect, however, credit market conditions will remain difficult for 18 months as banks move to re-coup losses and rebuild their capital base. The US housing market needs to improve. Once house prices begin to stabilise, banks can quantify their losses and resume lending.

### EUROPE

#### The need to follow suit

European equities, as measured by the FTSE AW – Developed Europe (ex UK) Price Index, declined around 10% in February.

As lending conditions have deteriorated, access to trade credit has become prohibitively expensive and as a result global trade came to an abrupt halt and continues to struggle. This has caused significant issues for the world's second largest exporter, Germany. Car producers have announced that they will reduce production as demand for their goods from overseas shrinks. We expect the recession to last through 2009 before a recovery in 2010 takes place.

The ECB aggressively cut official interest rates during the end of 2008, however failed to cut rates again in February (as most market participants had expected). But the ECB cut rates again in March and may even undertake 'quantitative easing', i.e. inject money into the financial system, to stimulate growth.

### Major Equity Markets – Total Returns £ 2008/2009

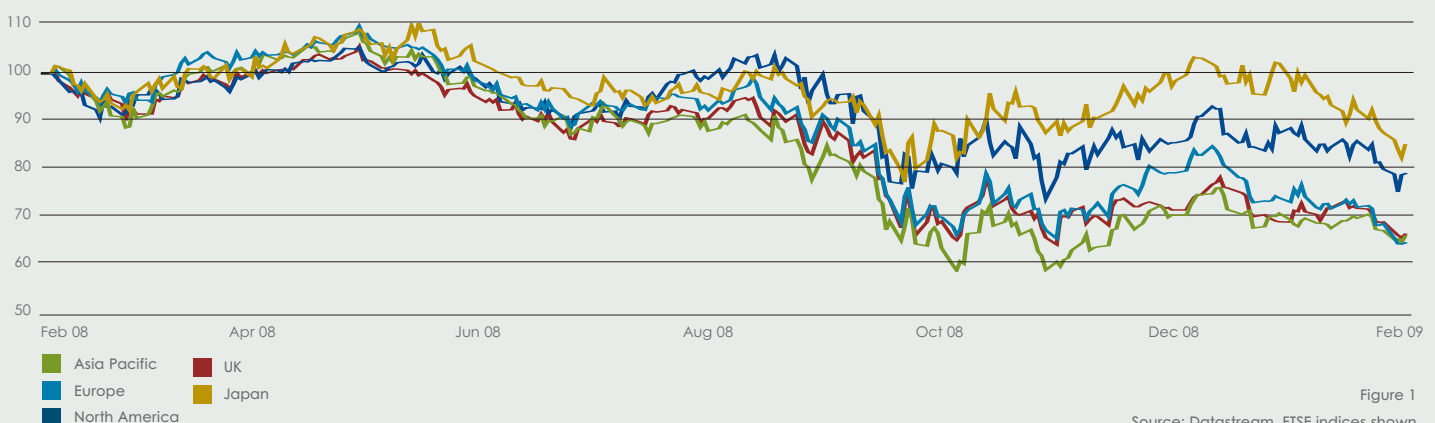


Figure 1

Source: Datastream, FTSE indices shown

## Equity Overview Contd.

### ▶ JAPAN

#### Slower still

Economic and corporate data remain very poor in Japan. The world's second largest economy shrank during the third quarter of 2008 and fell -12% (year-on-year) during the final quarter of the year - its worst performance since 1974.

Faced with a slowing global economy, Japanese exporting companies have reined in their spending, reduced production and many are cutting jobs. Canon Inc. and Toyota Motor Corp reduced their workforces towards the end of the year and electronics producer Sony Corp announced job cuts of around 5% of its workforce.

Over the month of February, the Japanese equity market (as measured by the FTSE AW – Japan total return index in sterling) lost around 11%.

### ▶ ASIA / EMERGING MARKETS

#### Trade stirs

Emerging economies have also fallen victim to the sharp deterioration in the global economic backdrop. Slowing growth has now spread from the developed western economies and is impacting China. The region has been particularly hurt by the dramatic decline in the availability of trade finance and the consequences this has for global trade. As equity market losses mount in the US and Europe, global investors have continued to aggressively reduce their exposure to emerging market regions irrespective of valuation.

While the Baltic Exchange Dry Index (a common barometer for global trade volumes) has almost tripled from its lows in December, it remains some 90% below where it was mid-2008, before trade completely froze when banks stopped lending. However, despite trade activity beginning to stir once more, major Asian economies such as Korea and Taiwan are continuing to struggle as consumers across the rest of the world are spending less.

The FTSE All World Asia-pacific ex-Japan Index fell almost 5% in February.

## Fixed Income

For some time now, investors have sought out the safety of government bonds as the economic backdrop deteriorated. US 10-year government bond yields are likely to remain abnormally low with quantitative easing underway. The UK government has also recently announced plans to buy gilts and corporate bonds using freshly created money. We have seen both retail and institutional investors' money flow into corporate bonds, attracted by the combination of extremely low valuations and attractive income yields.

Corporate bond markets will remain under pressure for some time despite governments and central banks providing significant stimulus to the financial system as defaults rise. For long-term investors, however, the returns offered by credit markets are extremely high, even factoring in the level of defaults witnessed during previous recessions.

Major Bond Markets – Total Returns £ 2008/2009



Figure 2  
Source: Datastream

# Snapshot

## Global manufacturing confidence

The collapse in global manufacturing confidence last autumn has now been confirmed by the deep contraction in official global trade and industrial production data. Any sign of a recovery in manufacturing confidence is likely to be taken positively by financial markets as it could signal an improvement in economic activity. The US manufacturing Institute of Supply Management (ISM) survey is probably the most widely followed measure of business confidence and there is a good chance of a significant rebound over the next few months.

Looking back at the thirteen post WWII US economic cycles, whenever the ISM has dropped below 43 and then stabilised, a decent bounce follows. We think this reflects the inventory cycle. Recessions are generally unanticipated. As demand falls, production is slow to respond and this leads to an involuntary build in inventories. Manufacturers then cut production in an effort to work off excess stocks. It is at this point that confidence is at its lowest ebb. Once inventories become leaner, production resumes and even if final sales growth remains subdued, confidence surveys tend to rise (Figure 1).

US manufacturing ISM cycles



Figure 1  
Source: LGIM, Reuters Ecowin

We believe global manufacturing is currently in the middle of a major inventory liquidation phase. Production has been cut dramatically to run-down inventories after the involuntary inventory build towards the end of last year. Many factories have either temporarily shut down or are operating with reduced hours. We expect some rebound in business confidence by the summer as production resumes.

In particular, attention should focus on new order balances in the confidence surveys. We show this in Figure 2 for both emerging market economies and the developed world. New orders have improved over the last couple of months after a dramatic decline late last year. The level is still extremely depressed, but we would expect new orders to lead an overall improvement in manufacturing confidence. For this recovery in confidence to be sustained it will require an improvement in underlying sales growth. This hinges on a restoration of credit flows. It's unclear at this stage whether the policy actions taken so far are sufficient to stabilise the financial system. So there is a risk of a renewed set back once restocking is complete.

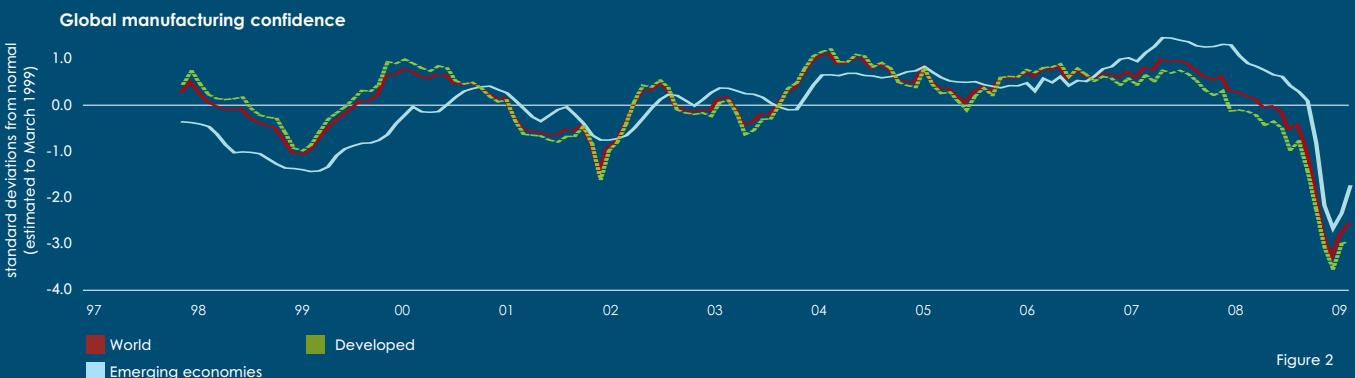


Figure 2  
Source LGIM, Reuters Ecowin

## UK Forecast

## Have growth expectations bottomed?

UK Economy		Price Inflation (HICP)		GDP (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro	
		Average 2009	Average 2010	Average 2009	Average 2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010
Market participants forecasts		%	%	%	%	%	%	%	%	%	%	%	%
	High	1.80	2.40	-2.50	2.40	4.10	4.30	0.75	2.00	1.74	1.83	1.06	1.00
	Low	0.10	0.90	-3.50	0.30	2.90	3.25	0.00	0.00	1.30	1.29	0.76	0.67
	Median	1.00	1.60	-2.70	0.70	3.15	3.83	0.50	0.50	1.50	1.58	0.87	0.83
	Last month median	0.90	1.70	-2.40	0.80	3.67	3.95	0.50	0.50	1.52	1.60	0.87	0.82
Legal & General Investment Management		0.90	1.80	-2.40	1.60			0.50	0.50				

Source: Bloomberg and LGIM estimates

Amidst the current volatile environment, the table has been altered to extend the range of forecasts to capture a greater sample size. This now reflects more up-to-date adjustments. 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.

Throughout the last year, our expectations for UK growth and Bank of England (BOE) base rates have been lower than consensus. But we now find ourselves slightly more optimistic than consensus, particularly for 2010. This mainly reflects a sharp turnaround in manufacturing activity with plant closures helping firms run down stocks of unsold goods and consumer spending beginning to stabilise following sharp cuts in interest rates and lower energy prices. A weaker pound should also help UK companies win market share.

Our forecasts for inflation are more in line with consensus, however. A reversal of last year's VAT cut should boost inflation towards 1<sup>3</sup>/<sub>4</sub>% in 2010 after averaging around 1% in 2009. But looking further out, we remain concerned about the risks of deflation given rising unemployment.

To offset this, the BOE has cut interest rates towards zero. Like consensus, we expect the base rate to remain at just 0.5% through the rest of 2009 and 2010. Consensus expectations for 2009 gilt yields have fallen by 50bp since last month as the BOE has begun taking more dramatic action to boost the economy. It has announced plans to buy £75bn of assets, of which £50bn will be gilts, with newly created money. This has pushed gilt yields down dramatically in recent weeks.

Printing money could undermine the pound. But other central banks are taking similarly aggressive measures to boost their economies. And if we're correct that the UK economy improves quicker than elsewhere, that might support the pound. Consensus expects the pound to recover to \$1.58 by end 2010 compared to less than \$1.40 now.

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