

## Great expectations

In September 2008 we outlined four key factors which could support an equity market recovery. We concluded then, that further economic weakness was needed to contain inflation, and if that were followed by aggressive policy easing and improved bank lending conditions, equity markets could rally mid-2009. Since then, as the global economy has continued to decline, governments and monetary authorities have synchronised an aggressive policy response and equities have rallied. Recent equity strength, however, has split market commentators. While some argue we are simply in the midst of a bear-market rally, others believe we have now seen the green shoots of an economic recovery which will support a more sustained rise in equity markets. In this edition of Fundamentals, LGIM's Equity Strategist, Georgina Taylor, explains what our research suggests.

### **Greenshoots or false start?**

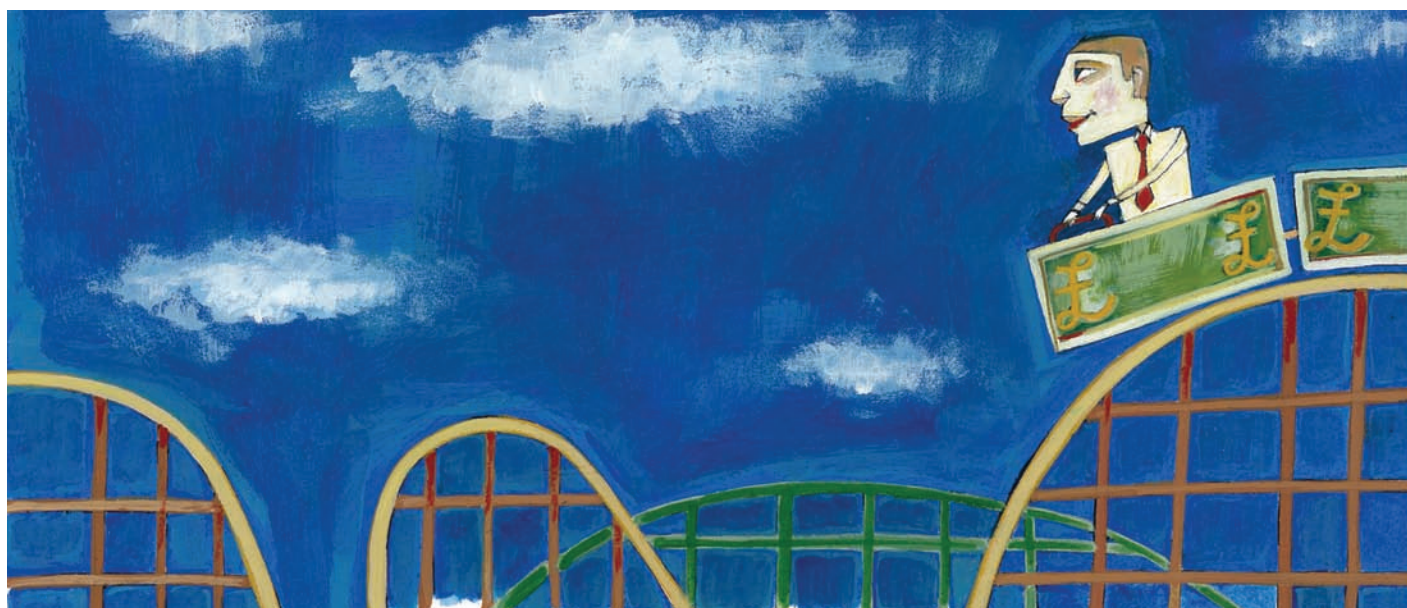
During the past eighteen months, as the banking turmoil spread and economic conditions deteriorated, financial markets performed very poorly. However, as investors expectations fell further with each new piece of negative information, the market priced in considerable economic weakness. As a result, recent economic

data is starting to positively surprise investors and this has underpinned recent equity market performance.

We believe that equity markets are now in a transition phase, where future gains hinge on whether these positive surprises cause investors to over-react and become too optimistic on the global economic outlook.

The question that will need to be asked: Is the rally just a short-term phenomenon or are these gains sustainable, underpinned by a typical cyclical economic recovery?

In September 2008 we highlighted four signals for a stock market recovery: valuations, inflation risk, loose monetary policy and economic growth. The timing of



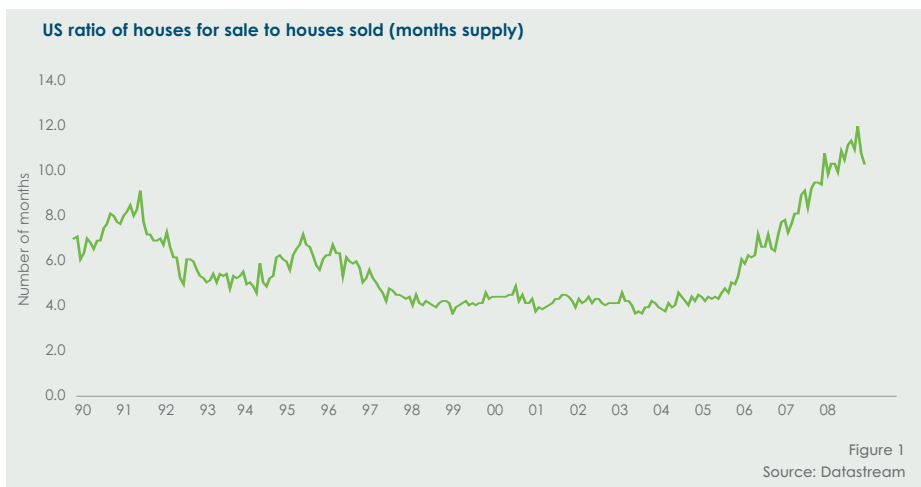
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an improvement in these factors was critical for a recovery in equity markets. Back in September only equity market valuation was starting to look supportive and even this brought its own concerns as it was important to be wary of the value trap, as we discussed in our November edition of Fundamentals. Since the end of September global equity markets are still down nearly 19% as at close on 8 May 2009.

However equity markets appeared to hit a low earlier this year and have now recovered nearly 30% since their low in mid-March. Typically, investors tend to value equities based on what they anticipate will happen in the future – so, if they behave as they have done historically, equities should start to move higher about six months before the economy turns around. To determine whether the recent equity market strength is sustainable, we believe it is critical to focus on a select number of economic indicators in order to gauge when the global economic cycle will begin to show signs of improvement.

### Signposts to recovery

A major global inventory cycle is behind the recent improvement in economic data. As demand collapsed last year, firms were initially slow to react and stocks of unsold goods increased. Companies then responded by cutting production in excess of the fall in demand. This has led to an aggressive inventory liquidation in the first quarter of this year. With inventories now

becoming better aligned with the level of sales, firms have started to resume production. Global trade has stabilized and business surveys have begun to improve. As the inventory cycle turns, it should mean that fewer jobs need to be shed. One of the most timely indicators is US initial jobless claims and this is an area where we anticipate a marked improvement over the next few weeks. US unemployment is still likely to rise further, but the pace at which it increases should diminish significantly.

The US housing market is critical for a sustained global economic recovery. US housing problems were at the epicentre of the credit crisis, taking us into the current economic downturn and we believe they will be a significant contributor to pulling us out. The US housing market is beginning to show signs of improvement as the months supply of unsold homes data has started to

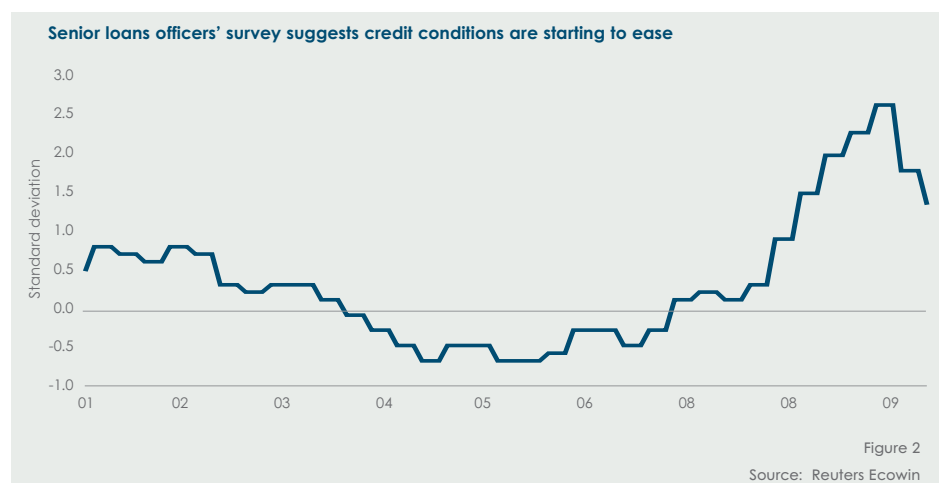
fall (Figure 1). Although new home sales have not yet markedly improved, they are showing some signs of stabilisation. We expect US house prices to start to stabilise towards the end of this year. This is important for the banks because if asset prices start to stabilise, losses can be quantified and both investors and the financial sector can start to take a view on the future.

### Credit where credit is due

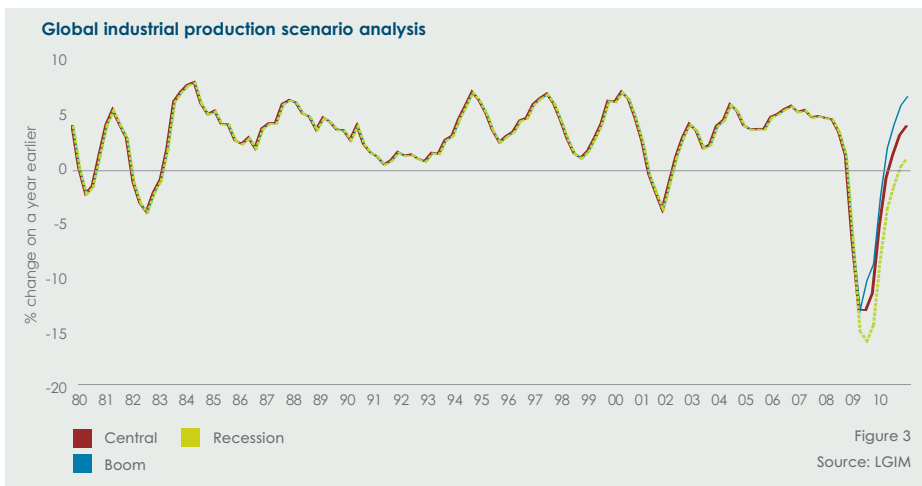
Credit conditions are also incredibly important. If consumers and companies cannot borrow, the economic recovery will be significantly hindered. Therefore we look at both the cost and availability of credit to assess the sustainability of the economic recovery. Credit spreads have started to tighten but remain wide by historical measures. Essentially while the cost of borrowing is starting to come down, it remains high relative to the past few years. The US Senior Loan Officers Survey gives a good indication of how tight credit conditions are and this survey has started to reflect an easing of credit conditions in the past couple of months (Figure 2).

### Managing expectations

Financial markets have performed poorly over the past eighteen months as expectations have been significantly downgraded to reflect the worsening economic backdrop. For example, when we wrote about valuation back in November, the markets still expected just a



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5% fall in UK profits growth this year. That figure is now -30% which is a significant downward shift in expectations for the profits outlook.

The historic relationship between equities and the economic and profits cycle suggests that equity markets start to price in the turn in the economic cycle about two quarters before the turn in the real economic data which appears to be what has driven equity markets higher over the past couple of months. However for equity markets to remain on an upward trajectory economic growth needs to pick up and stabilise in order for profits to start to meaningfully recover, to justify a continued recovery in equity prices.

Unfortunately this is where the risk for equities now lies. Our own economic forecasts suggest the global economy will start to recover towards the end of this year – which is a positive support for equities near-term. However, we believe that when it does occur, the eventual economic recovery will be very gradual and economic growth will remain below its long term average, at least during 2010, which is a negative drag on future profits growth.

### Give us a U, give us an L, give us a W, give us a V...

The second half of 2009 will likely be focused on the profile of economic recovery. At the moment investors can pick a letter to reflect their chosen profile for

economic growth from here. A V-shaped recovery symbolises a sharp pick-up in growth following a sharp decline, a U-shaped recovery means the economy spends more time in recession before turning around and a W-shaped recovery means that the economy double-dips into recession on its way back up. Our own projections suggest a near term recovery in growth followed by a prolonged period of sub-par growth as final demand remains lacklustre. Some have called this a square root profile for economic growth, where growth flat lines for a period of time after an initial bounce.

For equity markets to remain on a sustainable upward trend there needs to be more clarity as to the potential strength of growth from here. Therefore we believe it is important to assess the risk to our central case by comparing the fair value of equities under our core scenario versus a more pessimistic and a more optimistic outlook for the global economy.

To do this we have created three profiles for global industrial production: firstly our core scenario reflecting below average growth next year, secondly a deflationary scenario and finally a more optimistic scenario where growth recovers at an above average pace through 2010. These profiles are shown in Figure 3.

### Three scenarios

One way to assess the impact of these macro economic scenarios is to use the different macro inputs to generate a fair value target for the equity market. Here we focus on the FTSE 100 to give an indication as to the range of market levels which are justified based on different profiles for economic growth.

The key inputs to any fair value estimate are (i) a profits forecast for 2009 and 2010, (ii) a discount rate based on the bond yield and risk premium (iii) an estimate for long run potential growth which is usually based on trend real economic growth plus a long run estimate of inflation. Changing each of these inputs results in each of the scenarios outlined in Figure 4.

The biggest area of uncertainty in assessing the fair value of equities is what risk premium to use in a fair value model. The risk premium assesses the excess return required by equity investors over a risk free asset such as 10-year Government bonds and is used in calculating the cost of equity to discount future cash flows. There are therefore a number of ways that this can be calculated. We can look historically at the excess return achieved in equities over bonds which is around 3%. The other way is

The three scenarios				
	Implied market level	Change from current %	ERP assumption %	LT growth rate
<b>Central scenario</b>				
FTSE 100	4800	9.1	4.0	4.25
<b>Deflation scenario</b>				
FTSE 100	2800	-36.3	5.0	2.00
<b>Recovery scenario</b>				
FTSE 100	6500	47.8	4.0	4.25

This is based on FTSE 100 at 4,398 on 8 May 2009

Figure 4  
Source: LGIM

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to assess what risk premium is currently embedded in valuations to reflect an implied risk premium which is currently required by equity investors. This puts the risk premium at a much higher level of 5%. This makes sense as in the current environment risk appetite is low and therefore investors require a higher rate of return to compensate them for holding risky assets. The implied risk premium using forward valuation multiples is shown in Figure 5.

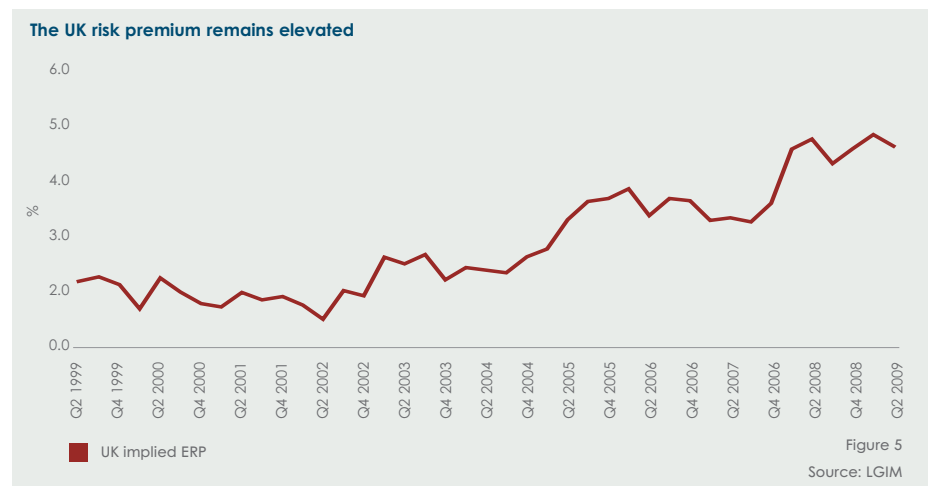
### Scenario 1: Our core view reflecting below average growth

We believe the global economy will show signs of recovery this year. However final demand will remain weak and therefore global economic growth in 2010 will remain below average. This is critical for equity markets as they are forward looking and price-in longer term potential growth as well as near-term profits prospects.

During a typical cyclical recovery equity markets look through near-term weakness and start to price in expectations of the strength of profits once the economy starts to recover. Our own economic forecasts suggest that profits growth in the UK will be fairly weak next year, at around 7%, after a significant fall in earnings this year. Under our central scenario we have kept our long-run potential growth estimate at 4.25% reflecting 2.25% average real economic growth plus a 2% inflation target. We have used a risk premium of 4% which is higher than a long run assumption of 3% to compensate in part for the 5% risk premium currently embedded in equity market valuations as discussed above. Under this scenario the fair value of the FTSE 100 is 4800 which would provide 9.1% upside from current levels.

### Scenario 2: Deflation takes hold

Our deflationary scenario looks at the impact of deflation and weaker growth on the fair value of the UK market. The main difference in this scenario versus our central scenario is that economic growth



remains very weak in 2010 and beyond and deflation takes hold. This doesn't influence profits growth this year all that much, however it means that profits growth in 2010 would be around zero, long term potential growth would fall back to 2% as inflation falls and the longer term risk premium assumption, in our view, would rise to 5%.

Under this type of scenario the fair value of the FTSE 100 falls dramatically to 2800 implying a potential 36.3% fall from current levels.

### Scenario 3: Road to recovery

Our recovery scenario is not an unrealistic boom scenario, but reflects a scenario where policy starts to drive economic recovery more convincingly than our core scenario would suggest, allowing profits to enjoy a more typical cyclical recovery next year.

Under our recovery scenario, profits growth this year would reflect a fall of around 25% rather than a fall of 50% and next year profits growth would be closer to 20% versus our core scenario of around 7%. Under this scenario the fair value of the FTSE 100 would be 6500 which is 47.8% upside from current levels.

### Hold on for the ride

In our view financial markets will move through different phases this year, trying to anticipate how much risk is associated

with any equity market returns. We are currently in a phase where investors expectations have fallen so low that current economic news is starting to positively surprise. As a result, equity markets have been driven higher. We believe that this could continue for the near-term as we believe that the economic data will continue to improve over the next few months, suggesting the turn in the economic cycle may be sooner than some thought.

The next challenge for financial markets will be to assess the strength of the eventual economic recovery. This is critical for taking a view on how far equity markets can rise, or fall, from here. Our central case for equities suggests there is still some upside. However we have also presented two different scenarios showing a dramatically different outlook for equity market prospects based on a deflationary versus a recovery scenario.

As the market continually re-prices the risks surrounding the strength of the cyclical recovery and whether inflation or deflation should be the main area of concern, equity markets will continue to be volatile leading to some weakness later on this year, in our view. More evidence is needed that the economic green shoots discussed above are improving enough to drive a sustainable recovery in economic growth and ultimately equity markets.

## Market Overview

Financial markets rallied in April as signs emerged that the economic backdrop was improving and credit conditions were stabilising. As manufacturing activity begins to stir again, surveys which track global sentiment have continued to improve and in many countries the increasing ability to obtain loans again has helped spur a rise in demand for homes and cars.

Major equity markets across the globe moved higher (in sterling terms) during March and April and while they remain highly volatile, it appears likely we have seen the lowest points from equity markets for this recessionary period. However, the sustainability of recent market strength has been brought under question (as our cover article has explained) meaning that further gains will hinge on the sustainability of the economic recovery.

## Equity Overview

### UK

#### Bumpy ride back

Falling mortgage rates, a combination of lower energy prices and a weaker pound and improvements in household balance sheets continue to support the UK economy.

While risks remain that policymakers fail to stop unemployment rising or that households decide to rebuild their savings more quickly than expected, we believe the outlook for the UK economy will be supported by improving manufacturing activity and increasing confidence over the next few months.

While there have been signs of improvement, the UK economy remains in a recessionary period and equity market conditions are likely to remain volatile, with a wide spread of returns across market sectors. Businesses with strong franchises whose incomes are less tied to the economic cycle are likely to perform better in this environment. We believe the greatest investment opportunities, however, will be in recovery situations in due course.

The UK equity market gained 9.5% during the month of April after rising 2.8% during March (as tracked by the FTSE All Share price index). Recent gains have paired back most of the losses in 2009, with the UK equity market just 1.6% lower than when it began the calendar year.

### US

#### Economic data improving

US Economic data have improved significantly over the past three months as the extent of recent fiscal and monetary stimulus efforts have begun to take effect. Lending conditions have recovered faster than anticipated and should continue to strengthen as house prices stabilise and corporate profitability improves. Recent innovative efforts by the Federal Reserve (Fed) are continuing to support credit markets and are beginning to help households and businesses obtain loans again. 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 such as the debt of government-sponsored enterprises (GSEs).

In response to the deteriorating operating environment, US firms cut back production during the crisis last year and as a result their stocks of inventories have fallen rapidly. To prevent further restocking, production is likely to resume and coupled with government spending, should help the US economy stabilise going into 2010.

US equities rose 7.9% in March and in April they traded 6.3% higher (measured by the FTSE All-World North America price index in sterling). Since the start of 2009 US equities are down -4.9% in sterling terms.

### EUROPE

#### Time to follow suit?

The European Central Bank (ECB) aggressively reduced official interest rates during the end of 2008, and continues to reduce them in 2009 (albeit slower than its peers in the UK and US). At the start of May, official rates have been reduced to 1% and the ECB has taken the first steps towards quantitative easing by buying bonds. Further measures might be required in order to stimulate growth.

While economic conditions remain difficult, fears of deep recession have been replaced during the past month by opportunistic investing, as tentative signs of economic activity and growth have emerged. Global trade ground to a halt last year as the credit crisis spread. More recently, global trade has begun to stir again. Shipping volumes are recovering slowly and demand (particular from China has begun to pick up). This has been positively received by many major European firms whose businesses rely heavily on exports.

European equities, as measured by the FTSE AW – Developed Europe (ex UK) Price Index, rose 8.2% in March and 10.3% in April. They remain down -7.9% for the 2009 calendar year to date.

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

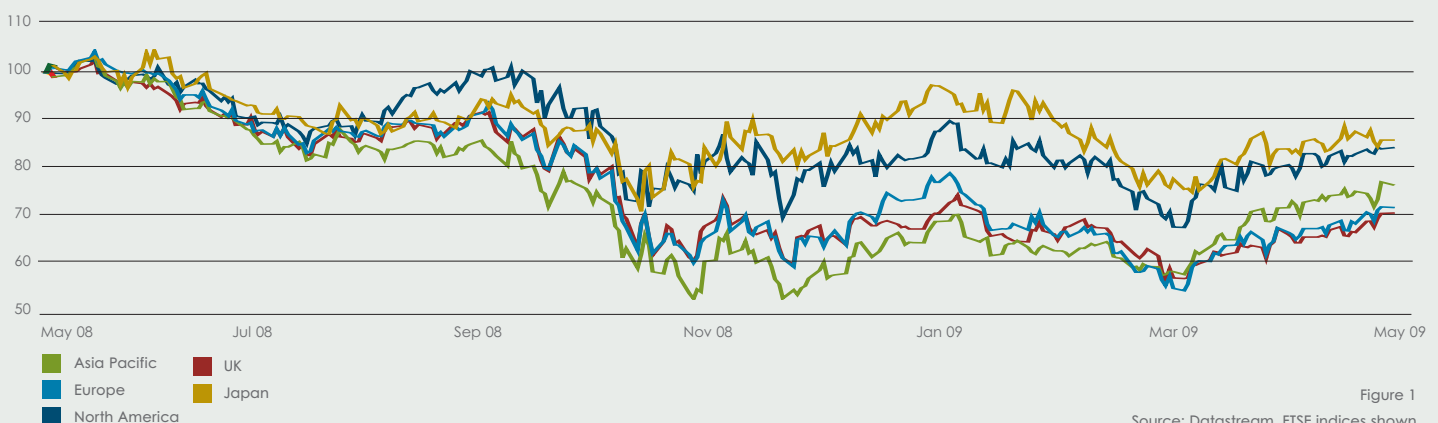


Figure 1

Source: Datastream, FTSE indices shown

## Equity Overview Contd.

### ▶ JAPAN

#### Down by not out

After declining significantly in February, the Japanese equity market rose slightly higher during the month of March and gained 5.8% in April (as measured by the FTSE AW – Japan total return index in sterling).

The rebound in US equities and tentative signs of strength from the global economy supported Japanese equities during the past month. Economic conditions in Japan remain bleak with exports remaining on a downward trend, business fixed investment declining, private consumption weakening and housing investment moving lower. Household income is also anticipated to decline as employment conditions worsen.

However, we believe that as world trade rebounds, the Japanese economy should strengthen by more than most economists are anticipating, and GDP growth for 2010 may be significantly higher than average market projections suggest.

### ▶ ASIA / EMERGING MARKETS

#### Strong gains amidst uncertainty

Asian equity markets rallied again in April. As a whole the market rose 11.3% during the month (as measured by the Asia Pacific Ex Japan price index in sterling), with equity markets in Hong Kong, Thailand, South Korea, India and Indonesia producing double digit returns. The Russian and Brazilian equity markets have also produced remarkable gains during the past two months after slumping significantly as commodity prices dropped suddenly amidst the global economic slowdown.

After rallying in March, emerging equity markets continued rising into April buoyed by positive economic news from across the globe, notably out of the US where banking liquidity programs and quantitative easing appears to be taking effect. While stocks have risen from

technically oversold levels, further gains may subside as companies take measures to rebuild their balance sheets and consumers move to replenish their savings throughout many developed economies.

While it remains negative, some of the recent export data being released in Asia suggest that global trade is beginning to pick up again. Since the end of last year, the dramatic decline in the availability of trade finance and the consequences this has for global trade has weighed on emerging equity markets. The Baltic Exchange Dry Index (a common barometer for global trade volumes) collapsed towards the end of 2008 and while it has risen significantly from its lows in December 2008, it remains some 90% below where it was mid-2008.

## Fixed Income

For some time now, investors have sought out the safety of government bonds as the economic backdrop deteriorated. Government bond yields in the US and UK are likely to remain abnormally low with monetary authorities activity expanding the money supply in order to stimulate economic activity ('quantitative easing'). More recently, 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.

The prospect of a sharp rise in credit defaults overhangs the market, while issuers from sectors that are more tied to the economic cycle are particularly vulnerable to ratings downgrades. However there has recently been strong demand for new issues, particularly in non-cyclical areas such as healthcare. We continue to believe that corporate bonds will outperform over the long-term, as from a valuation perspective we believe current yields offer more than sufficient compensation for the corresponding default risk.

Major Bond Markets – Total Returns £ 2008/2009



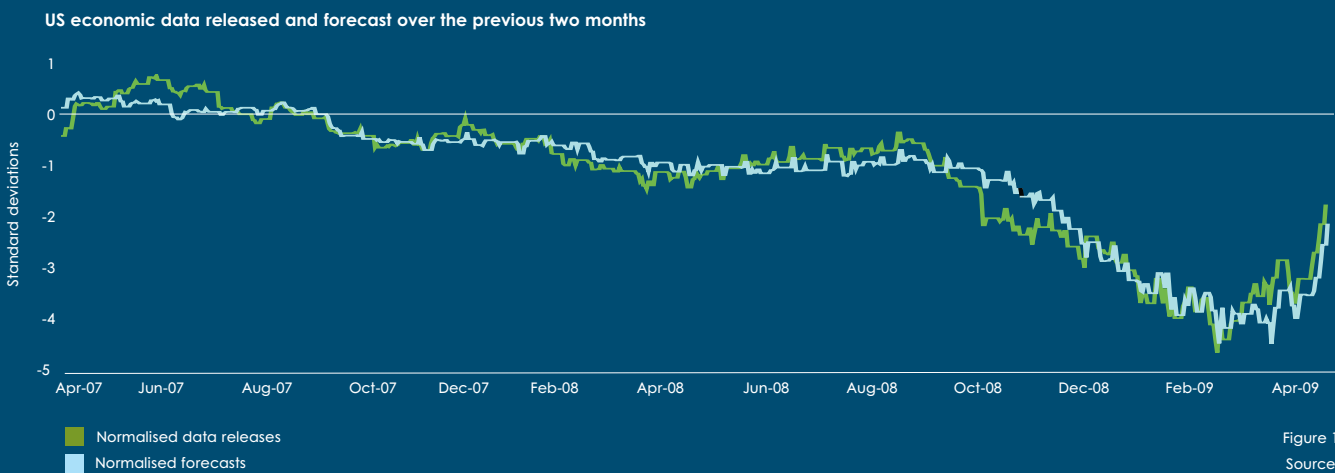
Figure 2

Source: Datastream

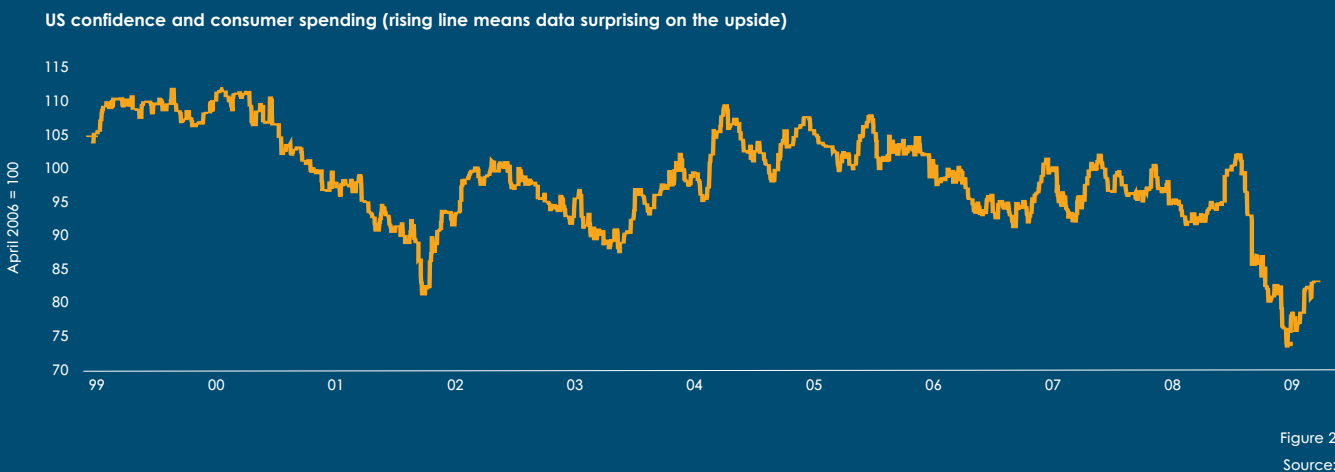
## Snapshot

# US economic data surprises

In recent weeks financial markets have rallied as tentative signs of a recovery have emerged. While many economies are still in recession, the pace of decline has eased. Expectations became so depressed that even marginally less bad economic data have generated positive surprises. We have quantified the scale of the data surprises for the US economy. We compare the actual numbers from several major economic releases such as the ISM, non-farm payrolls and retail sales with a survey of economists taken before the release. We calculate each data point's standard deviation from normal based on their history from 1997. We then aggregate the normalised actual data and repeat for the economists' forecast. The gap between the two series produces our US macro surprise indicator. If the normalised data are above economists' forecast, this is a positive surprise (Figure 1).



Since the summer of 2007, US economic data have been below normal indicating an economy growing below trend. There was a brief period following the Bush tax cuts in spring 2008 where the data surprised to the upside, even though growth remained lacklustre, but after the collapse of Lehman Brothers, data plunged and by far more than expected. Around the turn of the year, data generally met depressed expectations. More recently data has improved and by more than expected, generating a large positive surprise.



How long can data surprise to the upside? After a while economists will begin to factor in a further improvement. This makes it harder to beat raised expectations. Over the last 10 years, data have generally only surprised positively for a few months in a row. This is indicated by a rising line in the chart above (Figure 2). We think the turn in the US inventory cycle can deliver another couple of months of positive surprises. This could lead to widespread expectations of a decent recovery. This sets up a risk of a disappointment later in the year as we expect growth to remain sub-trend in 2010.

## UK Forecast

## UK to lead recovery

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	3.60	2.60	-2.00	2.00	4.60	4.80	1.50	2.00	1.86	1.90	0.96	0.98
	Low	0.70	0.70	-4.10	-0.40	2.75	2.75	0.25	0.50	1.30	1.35	0.78	0.72
	Median	1.30	1.50	-3.70	0.30	3.08	3.55	0.50	0.50	1.51	1.60	0.88	0.80
	Last month median	1.00	1.30	-3.30	0.40	3.08	3.34	0.50	n/a	1.50	1.59	0.87	0.80
<b>Legal &amp; General Investment Management</b>		<b>2.20</b>	<b>2.20</b>	<b>-3.10</b>	<b>1.90</b>	<b>3.00</b>	<b>3.50</b>	<b>0.50</b>	<b>0.50</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>

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.

During 2008 we remained more pessimistic on the prospects for the global economy than most market participants. As conditions deteriorated, however, economists wound back their forecasts, and this month we find ourselves more optimistic than consensus. While the global economy should remain weak by historical standards for the remainder of 2009, we expect a recovery as we head into 2010 as trade continues to improve and industrial production picks up.

We believe that the UK economy will outperform the US and European economies, given the extent of recent policy initiatives. With expectations now so low, UK economic growth has been surprising the market during the last month with its strength. Our fears surrounding UK GDP growth during the first quarter of this year were justified and we remain uncertain about the June quarter. However, our forecasts indicate a much stronger second half to 2009 as improving exports, government spending and business investment begin to stimulate the economy.

This month the median forecast from a Bloomberg survey of market participants shows the UK contracting -3.7% in 2009 and picking up only slightly in 2010 (at 0.3%). Alternatively, we anticipate a recovery of the magnitude of 1.9% for 2010 following a decline of 3.1% this year.

We anticipate higher inflation than the median forecaster, in the magnitude of 2.2% for 2009 and 2010. We feel consensus may need to revise up their inflation forecasts given lacklustre energy price cuts and rising import prices. We still remain confident that inflation will be subdued over the medium-term, however, as high unemployment will keep wages suppressed.

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