

## Grandpa's got a brand new bag



Ahead of the key Christmas trading period, many investors are worried about UK consumer spending given higher interest rates and a weaker housing market. They fear a re-run of 2004/05 when real spending grew at its weakest pace since 1992. In this month's issue of *Fundamentals*, James Carrick, Investment Strategist at Legal & General Investment Management argues that spending might hold up better than feared. Alongside a weaker housing market, the 2004 slowdown was partly driven by a tightening of credit card lending standards following a relaxation of bankruptcy laws. But consumer spending hasn't been driven by mortgage equity withdrawal or credit card lending over the past year. Instead it appears to reflect older people running down their savings and could therefore prove more resilient. Consumer spending is vulnerable to higher food and energy prices, but this applies more to emerging markets – where the consensus is optimistic – than the UK.

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This is the season to be jolly. So it's time we spread some good cheer after a series of cautious *Fundamentals* warning about credit crunches and oil price spikes. Many investors are worried about the implications of higher interest rates and a weaker housing market on UK retail spending during the key Christmas period. There are three main

concerns. First, a reduction in housing transactions will reduce spending on related items such as furniture. Second, slower house price inflation (if not actual falls in prices) will discourage households from withdrawing equity from their home. Finally, higher mortgage payments will squeeze consumers' spending power.

UK CONSUMPTION WAS WEAKER THAN OUR MODEL EXPECTED IN 2004/05

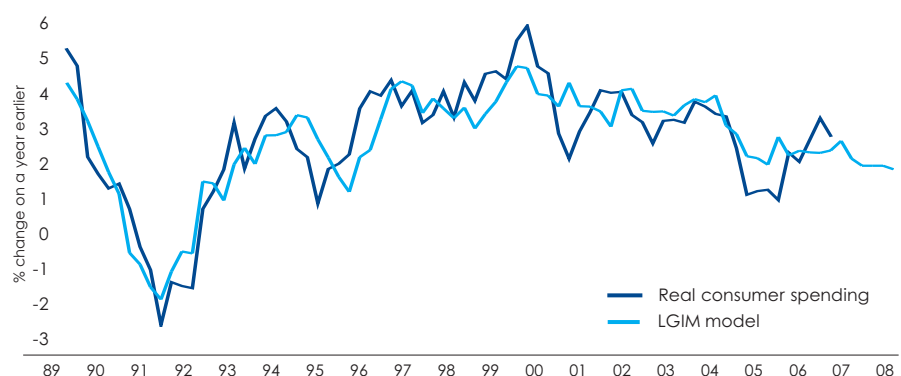


Figure 1

Source: Reuters Ecowin, LGIM estimates

WEAKER HOUSING RELATED SALES ONLY EXPLAINED A FIFTH OF THE DOWNTURN IN RETAIL SALES IN 2004/2005

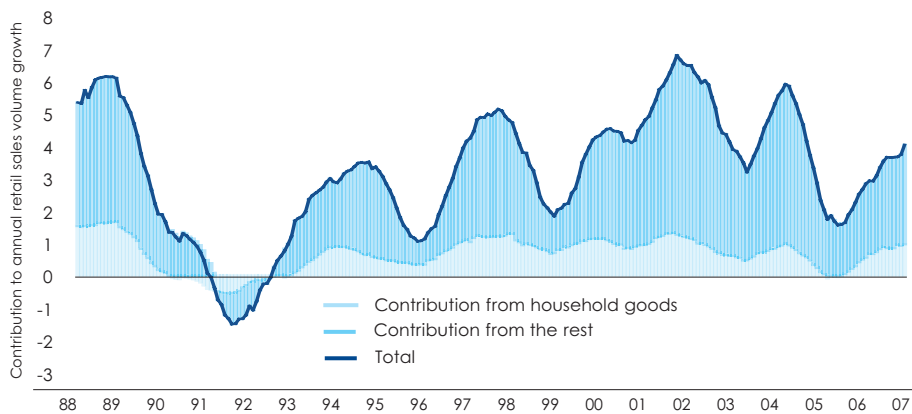


Figure 2 Source: Reuters Ecowin, LGIM estimates

While we certainly accept that housing related spending will fall, we don't believe this was the reason consumer spending slowed so much in 2004. The slowdown was driven by non-interest-rate sensitive items such as food, restaurants and gambling, which we believe was related to a sharp tightening of credit-card lending conditions. But over the past year both credit card lending and mortgage equity withdrawal have been subdued, suggesting limited scope for another collapse.

Moreover, unlike in 2004, most UK mortgages are currently fixed for 2-3 years. So the increase in mortgage repayments should be more gradual than before and fixed-rate mortgage rates have also started to come down following the rally in global bond markets. The biggest risk to UK consumer spending comes from higher food and energy prices which will boost headline inflation. But this is a global risk, so it should effect emerging market growth more than the UK given poorer people spend a greater share of their income on such necessities than richer ones.

The Bank of England was surprised by the speed of the consumer slowdown in 2004. Figure 1 helps explain why. We plot real consumer spending against our model which is based on fundamental drivers – real incomes (unemployment, wages, consumer

price inflation), wealth (house prices) and interest rates. Consumer spending was weaker than the model predicted in 2005. In the past we have blamed this on John Maynard Keynes' famous animal spirits. Mervyn King actively talked down the housing market in 2004. So although house prices continued to rise during this period, surveys showed only a minority of consumers actually thought this would happen. Estate agents also reported the largest fall in asking prices since 1993.

But after delving into the details (Figure 2), we struggle to find convincing evidence that the slowdown in consumer spending was housing related. For example household goods sales (such as furniture), which are highly correlated with mortgage applications, only contributed 1

percentage point of the 4.6 percentage point peak-to-trough reduction in total retail sales (20% of the total). How do we explain the remaining 80%?

In Figure 3 we look at the resources that households had for consumption. In cash terms (so ignoring the impact of changes in energy prices on the volume of goods bought for example) spending grew by £8bn less in 2005 than it did in 2004. This was despite wages and salaries rising by £4.5bn more than before. So consumer income growth increased but spending slowed (a divergence of £12.5bn).

Much of this difference can be explained by an £8.5bn swing in consumer credit (it fell in 2005 after rising rapidly in 2004). The rest seems due to either lagged effects of weaker mortgage equity withdrawal (which fell by £11bn in 2004 but was broadly unchanged in 2005) or the nearly £6bn increase in pension contributions (the switch from defined benefit to defined contribution schemes either forced or encouraged households to save more).

Why does this matter? Because if we are to expect a repeat of the sharp slowdown in consumer spending that we saw in 2004/05, we should see the same drivers in place – weaker credit card lending and mortgage equity withdrawal alongside a rise in pension contributions.

CONSUMER SPENDING GREW AT A SLOWER PACE IN 2005 DESPITE AN ACCELERATION IN LABOUR INCOMES

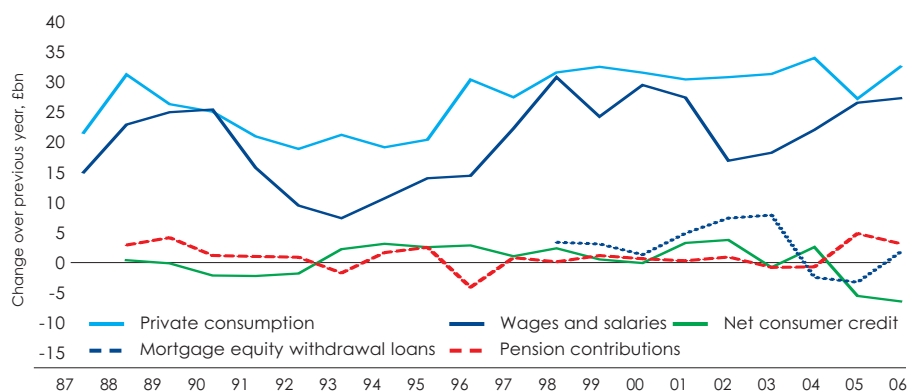


Figure 3 Source: Reuters Ecowin

CREDIT CARD ISSUANCE STARTED TO FALL IN 2004 AS CONSUMERS VOLUNTARILY DECLARED THEMSELVES BANKRUPT

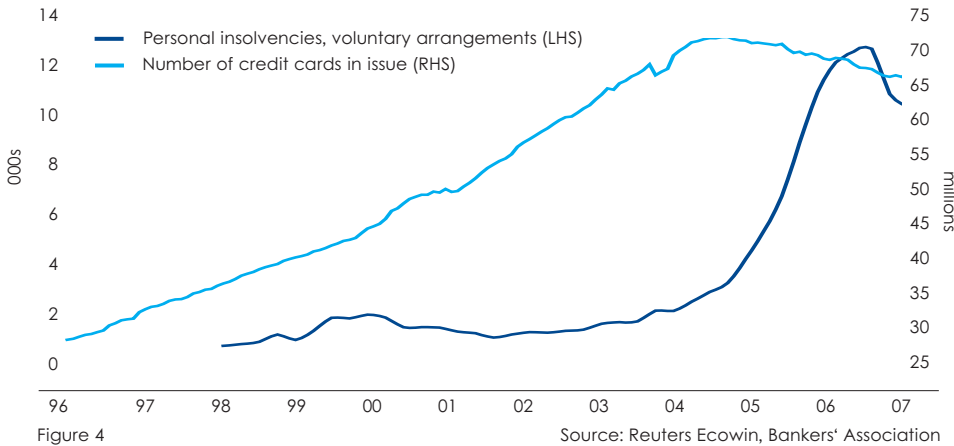


Figure 4

Source: Reuters Ecwin, Bankers' Association

But over the past year credit card lending and mortgage equity withdrawal have been weak. Indeed, the number of credit cards in issue has been falling consistently since 2004 (Figure 4). In April of that year, the law on bankruptcies was relaxed leading to a surge in people declaring themselves bankrupt through individual voluntary agreements (IVAs) to avoid paying off their debts. This caused credit card companies to tighten lending criteria, putting an end to so called 'rate tarts' who kept on switching from one credit card to another, taking advantage of 'interest-free deals' and not paying off any of the principal outstanding.

What about secured lending? Although credit cards are harder to come by than before, with house prices rising, surely people have been taking advantage of this and releasing equity from their homes? Again, the data doesn't support this stereotypical view. The number of mortgage equity release loans (typically worth around £20,000 each, suggesting they are used for big ticket purchases or to pay down other debt) have again, fallen consistently since 2004 (Figure 5).

So there is little evidence that UK consumer spending has been driven by credit card lending or mortgage equity withdrawal over the past year. But the saving ratio has fallen. How can this be? Saving is the difference between income and spending. If people are saving less it suggests spending is growing faster

than incomes. There are two ways this can happen. First, borrowers (young indebted people for example) can borrow more. Alternatively, savers (older, wealthier people for example) can save less. It's a subtle but important difference.

We think older people have been saving less in recent years. Perhaps they've been forced to run down their savings to meet higher energy costs. Alternatively, they might have recently 'downsized' their property, selling a large home to a younger family or investor and moving into a smaller home or rented accommodation. A combination of higher wealth and rising interest rates (which mean fewer assets are needed to generate a given level of income) might have encouraged them to draw down some of their savings.

There are two ways to illustrate this. In figure 6, we show household spending by age. In 2004 and 2005, households aged below 30 spent less in absolute terms than they did in 2003. This reinforces the view that younger people were squeezed by a combination of tighter lending standards and higher mortgage rates. But spending by people aged over 75 has risen by 15% over that same two-year period. So it has arguably been grandpa – rather than grandson – that has been driving the UK economy in recent years.

In figure 7, we reinforce this view in a different, more technical way. Between 2001 and 2004, the household saving rate fell from a high of 7.3% of disposable income to a low of 3.2%. You can see that this was driven by a sharp increase in the amount of debt taken on by households. This went from 10.8% of income to 18.1% over the same period. We saw some retrenchment in 2005. The saving ratio rose back to 6.6% as debt acquisition fell back. But since the end of 2005, the saving ratio has fallen again, even though debt accumulation has stabilised. How come? Because the other line in the chart – asset acquisition has fallen back.

We think this is important because in the wake of a credit crunch, spending is more sustainable if it is driven by people saving less than if it was due to

MORTGAGE EQUITY WITHDRAWAL LOANS HAVE BEEN WEAK IN RECENT YEARS

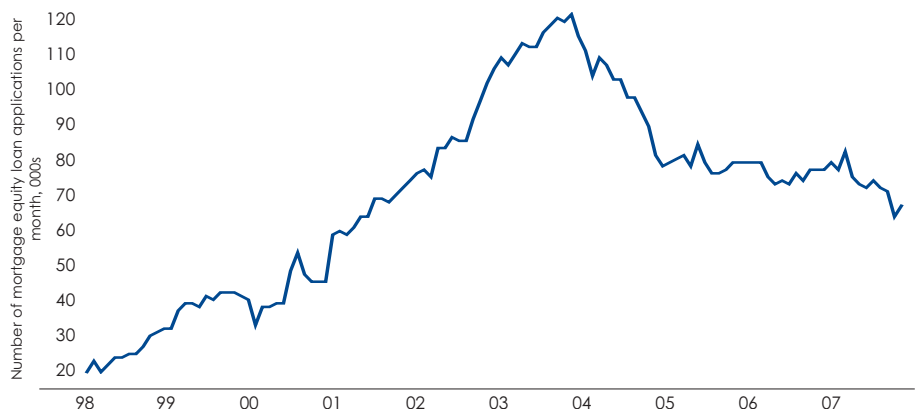


Figure 5

Source: Bank of England

people borrowing more. Although credit card lending standards will probably be tightened again, it's unclear that we can have another £8.5bn slump in credit card lending given it has been weak in recent years. And although people will undoubtedly spend less on furniture as we see housing transactions drop, we don't think mortgage equity loans can drop by £11bn again. It's also unclear if we will see another sharp rise in pension contributions.

Our final positive argument for the UK consumer is the increased share of fixed-rate mortgages. Back in 2004, the majority of mortgages were short-term variable ones which reset on a monthly basis. So as the Bank of England hiked interest rates through the summer of 2004, the pain was felt immediately by consumers, forcing them to curb spending. This time, we estimate that the majority of the value of mortgages is currently fixed for 2-3 years. This means that the pain of interest rate rises will be felt over a sustained period of time. The impact on growth – the rate of change of spending – therefore, should be more modest, particularly as households' incomes should rise over the period. And that leads us to our downside risks.

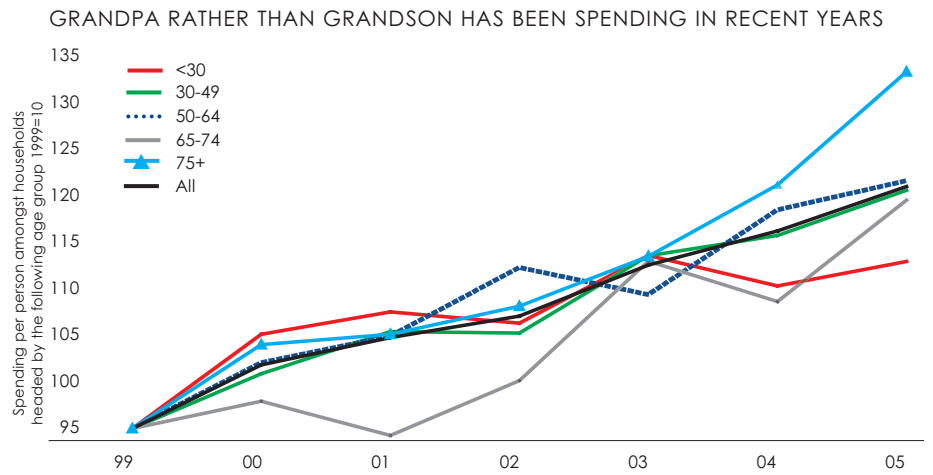


Figure 6

Source: National Statistics, LGIM estimates

As we argued in last month's Fundamentals ('Return to Sender'), a combination of supply shortages and inelastic demand has the potential to cause energy prices to surge. This could have knock on effects on food prices as more foods are diverted towards bio-fuels and as transport costs increase. Higher food and energy prices reduce people's spending power in the same way that higher mortgage rates do.

Arguably, higher energy and food prices pose greater risks to emerging markets – where consensus is bullish – than the UK. This is because poorer households in emerging markets spend a greater share of their incomes on the necessities of life such as food and energy than those in developed economies like the UK, who spend

more on services such as satellite TV. Recent protests in countries like Burma and Georgia have coincided with spikes in inflation. For example the latest official estimates show Burma inflation spiking to 28%, eerily similar to the rise in Chinese inflation that occurred in 1989 just before the Tiananmen Square protests. In many emerging markets, the inflation problems have been hidden by fixed prices. For example, Russia has frozen food prices until after the elections in December. But this is just storing up problems for the future. And while investors are currently complacent about emerging market growth and worried about UK consumer spending, the reverse could be true as we head into 2008.

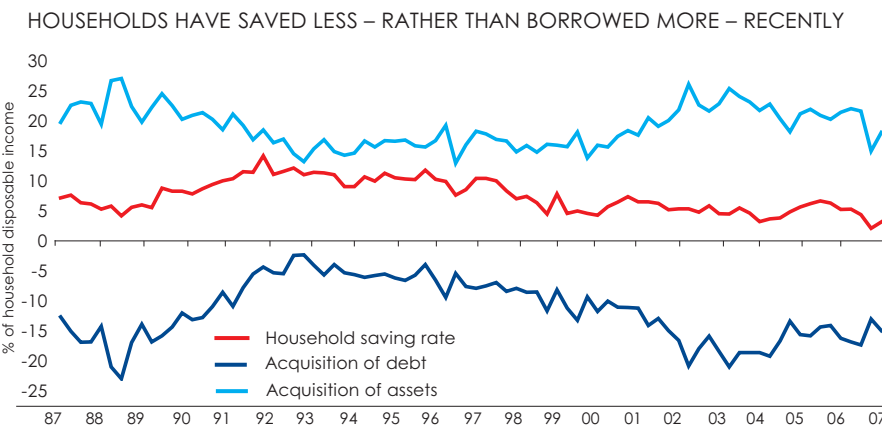


Figure 7

Source: Reuters Ecwin, ABN AMRO

## Market Overview

# Banks hit hard by sub-prime losses

The market rallied through the beginning of October continuing the momentum seen after the 50bp cut in the target rate by the Fed on the 18 September. Momentum slowed mid month as renewed concerns of sub-prime problems hit the headlines again as major US banks posted third quarter losses due to large write downs associated with the asset backed securities at the heart of the sub-prime problem. These fears were slightly alleviated as the market speculated that the Fed would cut rates again to help. And on the 31 October it did once again cut rates, this time only 25bp, but the statement accompanying the cut highlighted upside risks to inflation offsetting downward risks to growth, and this sent the markets tumbling in the first week of November.

Oil reached record highs over the month trading above \$98, on the back of a weaker dollar and the shutting of North Sea oil platforms as forecasters predicted 36 foot waves in the region as weather deteriorated.

## London

### Probably the best takeover in the world

The UK equity market continued to recover strongly in October with a total return of 4.4%. Midcaps returned 5.9% beating both the FTSE 100 and Small cap indices which returned 4.1% and 2.9% respectively. Sector leadership was again provided by the Oil sector as the oil price moved higher, whilst continuing concerns about the liquidity crisis saw Financials remain under pressure. Poor company newsflow saw further underperformance from the Pharmaceuticals stocks and whilst the Housebuilding sector suffered from continuing fears of a slowdown. M&A activity continued with a joint bid by Carlsberg and Heineken for Scottish & Newcastle. There were also developments in the battle for ownership of Resolution Life. News on corporate profits was mixed with positive news from Tesco in contrast to a warning from Rank Group. We maintain a positive long term view on the UK equity market although we expect volatility in the short term.

## Wall Street

### Big write offs at financials

The S&P 500 was up 1.5% in October. Information technology, utility and material stocks were the top performers. The U.S dollar continued its decline versus major world currencies. Crude oil hit a new all time high after rising 16% over the month.

Economic data over the period continued to disappoint.

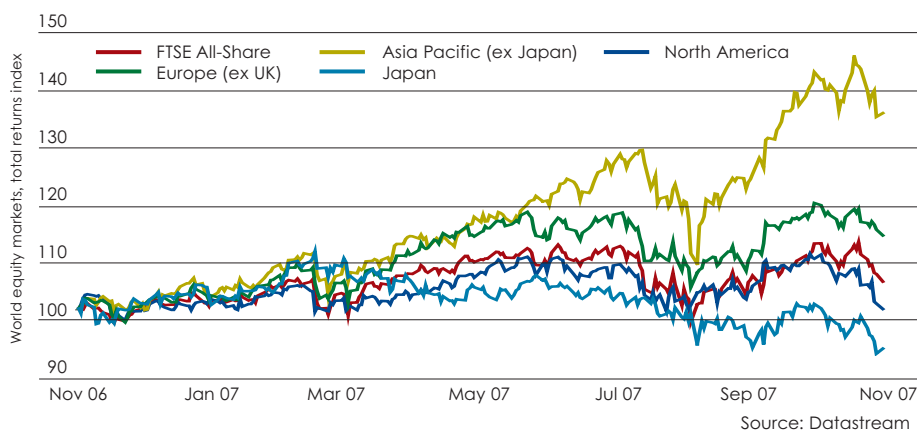
Housing starts fell significantly and existing home sales were down 8% month on month. Industrial activity moderated some what and consumer sentiment surveys show continued deterioration. The Federal Reserve lowered key rates a further 25bp but Fed members remain concerned about building inflationary pressures.

### Outlook

With 60% of the S&P 500 companies having reported third quarter earnings so far. Earnings are down approx 2% year on year. Financial company earnings are down 25% as several large institutions have been forced to write down the value of their loan portfolios. Ex-financial, earnings grew 8% year on year. Technology and healthcare companies posted the best results relative to expectations.

S&P 500 earnings estimates for 2008 are calling for 12% year on year growth. Consumer discretionary and financial companies are expected to deliver robust profits growth after a lacklustre 2007. The rebound in profitability for these sectors partly reflects lower asset impairment charges tied to loans or the value of unsold homes and land for the homebuilding sector. Bank earnings will continue to face a headwind from higher provisioning and the housing market downturn has shown no signs of abating. We remain cautious about the near term prospects for both of these sectors.

MAJOR EQUITY MARKETS – TOTAL RETURNS £ 2006/2007



## Europe

### Financials still weak

Even though the European Central Bank is not cutting interest rates in the same way as the Federal Reserve, equity markets in Europe rose by an aggregate 2.1% in October in sterling terms. Returns to overseas investors were enhanced further by the strength of the euro, responding as it did to the narrowing differential of US interest rates over European rates. Unlike the Fed, the ECB has proven intransigent in the face of incipient inflationary pressures, notwithstanding the weakness in selected property markets. One of the key components of this is the rising oil price, with most of continental Europe, and Germany in particular, a significant importer of oil and oil products. As price rises in this and other commodities are passed along production value chains they ultimately result in higher consumer price inflation, and it is concern in this regard that is staying the ECB's hand in cutting rates, if not promoting a bias towards increasing rates.

Underlying macro and microeconomic performance nonetheless remains healthy around Europe, inflation excepted. Industrial production growth is healthy in the core markets, driven by gradual improvements in domestic economies and enhanced by demand from emerging economies in Asia and Eastern Europe. We expect these phenomena to continue, owing to the secular growth that is occurring in these regions. As a result revenue growth at companies within the capital goods and transportation sectors in particular can be expected to continue to be strong; further down such companies' income statements, however, there will be some pressure, owing to higher input costs and the higher euro.

Areas where we expect weakness to continue include the financial sector, as the domino effect from the sub-prime mortgage crisis in the US continues, and especially those financial stocks geared into poor domestic housing markets, such as the Irish banks. On balance, however, with the Fed prepared to react to weakness in what remains the engine of growth for the world, the US economy, we remain favourably disposed towards the European markets, offering as they do an attractive combination of healthy top-line growth and low valuations. The momentum of the last two months should be sustained, unless the ECB decides to be aggressively hawkish on inflation and raise rates, or the financial crisis in the US worsens materially.

## Japan

### Exporters face dollar headache

The Japanese markets have seen volatility in recent weeks as concerns about the US sub-prime situation and global slowdown continue to resurface. Results season is about to commence in earnest and investors will be looking for evidence of any weakness in the core export regions, particularly the US and China. The Yen has strengthened from its highs this year, but remains bearable for Japanese exporters around ¥114/USD. So far out of the major exporters, Honda and Nissan have positively surprised at the half year stage, both reporting better than expected sales, so far seeing few signs of a slowdown in the core US market.

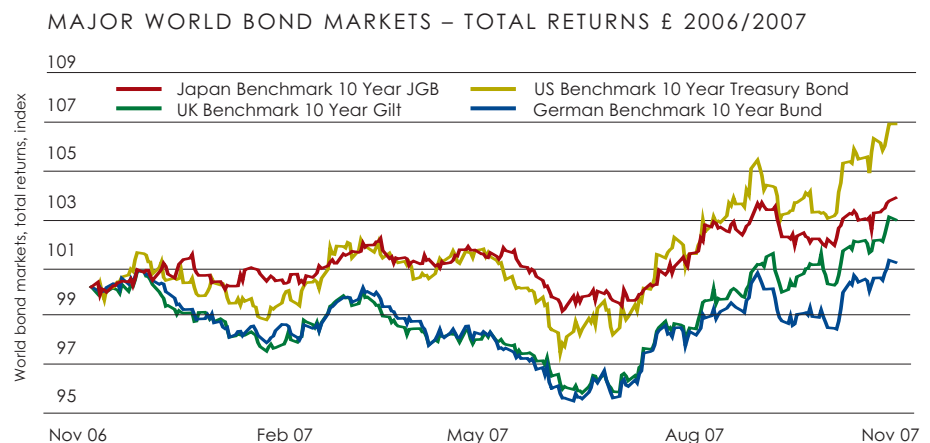
Domestically economic data continues to disappoint, with the unemployment rate edging up to 4% at the latest reading and consumer confidence still muted. Falling consumer prices in Japan continue to make difficult for the authorities to raise interest rates.

## Pacific Basin

### Chinese gamblers euphoric

In October the FTSE AW Asia Pacific Index performed strongly rising 7.7% in sterling terms. The emerging markets of Asia led the way with India up 15.2%, China up 14.4% and Indonesia rising 14.6%. The laggards were Singapore (+2.8%), Philippines (+3.2%) and Taiwan (+3.5%). The enthusiasm for Chinese H shares and red chips was driven by the euphoric response of Chinese mainland investors to QDII funds which can be invested in Hong Kong. A further catalyst – later denied – was the rumour that the government was considering to allow Chinese A and H shares to be swapped to close the valuation gap.

India has recorded almost US\$19bn of foreign net inflows so far in 2007. This has put upward pressure on the Indian Rupee which has appreciated by over 11% relative to the dollar. To moderate the record capital flows to the market the regulatory authorities issued a proposal to curb the use of participatory notes thereby forcing foreign investors to go through the Foreign Institutional Investor qualification process. Asian stockmarkets have performed strongly in the past two months driven by Hong Kong/China and India and may be overdue a period of consolidation before the next stage of the bull market. Premier Wen Jiabao's statement that domestic Chinese individuals' investment overseas into the Hong Kong market will be delayed may provide that catalyst.



Source: Datastream

# Snapshot

## US retail sales and gasoline prices

Gasoline prices are a more important driver of US consumer spending in the short term than home prices. So surging oil prices and a weaker dollar could depress US growth forecasts as we head into 2008.

Many investors have been worried that a weaker housing market will depress US consumer spending. Lower wealth might encourage households to save more. Alternatively, an inability to raise money based on the value of their home might force them to borrow less.

The housing market has certainly deteriorated. New home sales peaked in July 2005 and have fallen by around 45% since then. House prices are estimated to have peaked a year later, and have since fallen by around 5%, according to the Case-Shiller measure. But so far, the consumer hasn't given in. In the third quarter of 2007, real US consumer spending rose at an annualised rate of 3%, in line with the growth over the previous year.

So some bears on the US consumer have capitulated. But this might be a bit premature. Our analysis suggests that real incomes are a more important driver of consumer spending than wealth. And one of the components of real incomes – prices are currently surging. Gasoline futures prices have risen by 20% since the end of September. Retail prices have started to follow suit.

If we combine retail gasoline prices with effective mortgage rates, we get a good lead indicator for US consumer spending. (Figure 1) This pointed to strong spending over the summer, which we duly saw, but points to a significant deterioration as we move into 2008.

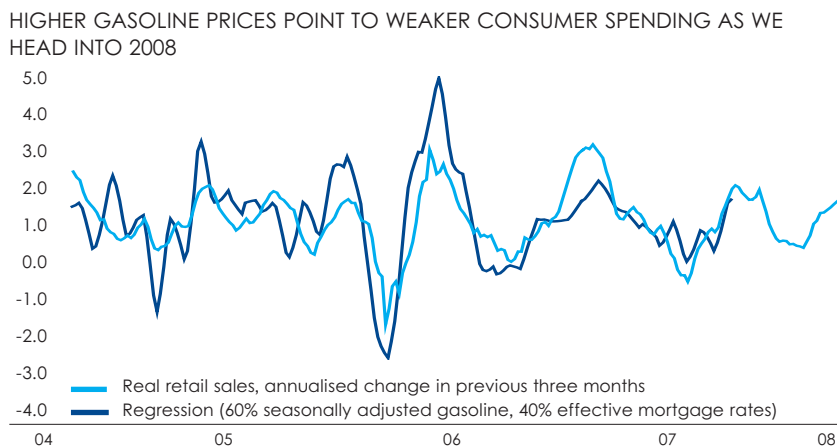


Figure 1

Source: Reuters Ecowin, LGIM estimates

To make matters worse, this is likely to have significant spill over effects on the manufacturing sector. Despite strong export growth, US manufacturers are currently reporting that their customers' inventory levels are the highest since January 2001 (Figure 2). In other words, they have so many goods they don't need to order any more. If this is the situation when gasoline prices are low, it is likely to get much worse as energy prices sap consumer spending power.

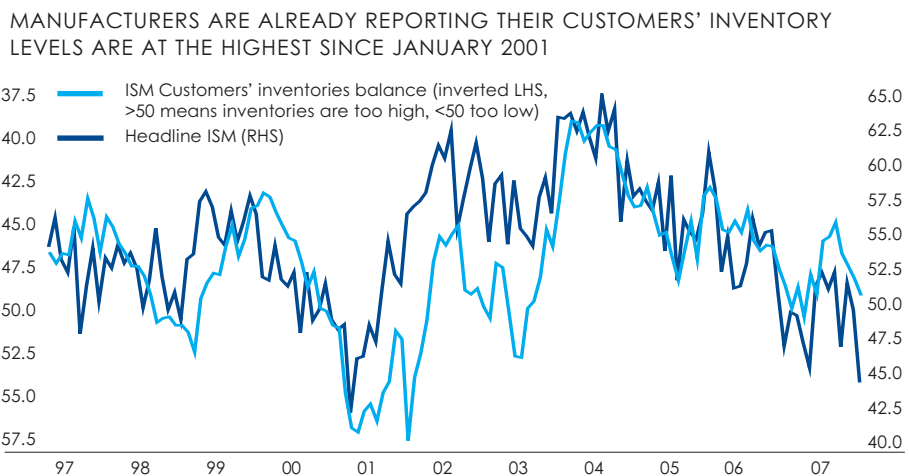


Figure 2

Source: Reuters Ecowin

## Views Commentary

## Sub-prime annihilates earnings

	Price Inflation (HICP)		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 2008
ABN Amro	2.30	2.20	3.10	2.10	5.50	5.00	4.95	4.65	5.75	5.25	2.09	2.12	0.71	0.72	7200
Citigroup Smith Barney	-	-	3.10	2.20	5.30	10.30	5.09	5.48	5.50	5.25	2.00	2.01	0.71	0.72	7200
CSFB	1.80	2.00	2.90	2.20	-	-	4.80	4.75	5.75	5.25	2.01	1.83	0.72	0.75	7400
Deutsche Bank	2.30	1.80	2.90	1.80	5.80	8.10	5.00	5.00	5.75	5.25	-	1.89	0.69	0.74	7600
Goldman Sachs	1.80	2.10	2.90	1.70	2.60	10.30	4.80	4.90	5.75	5.00	2.07	2.07	0.70	0.72	-
HSBC Securities	1.70	1.60	2.70	1.70	7.00	4.00	4.60	4.60	5.75	5.00	2.04	1.83	0.71	0.74	7500
JPMorgan	2.34	2.15	3.17	2.51	6.00	7.00	4.90	-	5.75	5.50	2.03	-	0.67	-	-
L&G Investment Management	2.00	2.00	2.90	2.20	6.00	4.00	5.10	5.00	5.75	5.50	2.05	2.10	0.69	0.71	6825*
Merrill Lynch	2.30	1.90	3.00	2.20	6.50	8.00	4.85	4.80	5.75	5.00	2.06	1.84	0.68	0.70	6960
Morgan Stanley	2.00	1.90	3.00	2.00	6.00	6.00	5.30	5.30	5.50	5.25	2.03	1.88	0.70	0.69	-
UBS	1.80	1.80	3.00	2.00	5.30	8.20	5.04	5.20	5.75	5.25	2.00	1.90	0.71	0.71	7200
Median (ex L&G Inv Mgt)	2.00	1.90	3.00	2.05	5.80	8.00	4.93	4.90	5.75	5.25	2.03	1.89	0.70	0.72	7200
Last Month	2.20	2.10	2.90	2.05	6.10	7.60	5.00	4.95	5.75	5.25	2.04	1.90	0.70	0.72	7151
Actual end :															
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
2004		2.50		2.60		6.71		4.53		4.75		1.92		0.71	4814

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.

After two consecutive months of lowering the base rate forecast, respondents to our survey have held their prediction for the 2008 base rate at 5.25%. They have however revised down once again the Gilt yield forecasts as bond markets continue to be affected by credit concerns.

Earnings forecasts for 2007 continue to be revised down as US banks have started posting write downs on the sub-prime assets on their balance sheets. But respondents expect 2008 earnings to bounce back as companies recover from the credit crisis.

Inflation forecasts have decreased this month after the lower than expected outcome in September.

For further comment on Fundamentals, or for additional copies, please contact Harriet Moore at [harriet.moore@lgim.co.uk](mailto:harriet.moore@lgim.co.uk)  
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