

Mind the Gap

This time last year we flagged a cautious outlook for equities in our Fundamentals article 'Beware the Value Trap'. Despite seemingly attractive valuations, we felt significant risks remained to earnings and dividends as the credit crunch and global recession derailed the market. UK equities traded another 20% lower between November and March. In May's note 'Great Expectations', we described how equity markets were getting back on track and that more realistic earnings expectations coupled with an improvement in macroeconomic and credit conditions could send prices higher. The FTSE 100 is now trading some 50% above its March lows, in a large part due to the extraordinary measures that policy makers have taken to inject liquidity into the financial system and stimulate economic activity. In this edition of Fundamentals, LGIM's Equity Strategist, Georgina Taylor, projects how equities will perform as markets start to question when this liquidity will be withdrawn, and the focus shifts to more traditional drivers of economic growth.

Key factors driving equity markets:

	Now	2010
1. Loose Government Policy	✓	?
2. Economic Growth	✓	?
3. Low inflation	✓	✓
4. Valuations	✓	✓

Source: Reuters Ecowin/LGIM estimates

Our framework for equities is based around four factors: government policy, economic growth, inflation and valuations. Back in May all these factors supported a continued rise in equity prices. Today, however, we believe there is significant uncertainty

surrounding how much longer governments can maintain such accommodative policy measures and whether the improvements in economic growth that have begun to emerge can be sustained through next year.



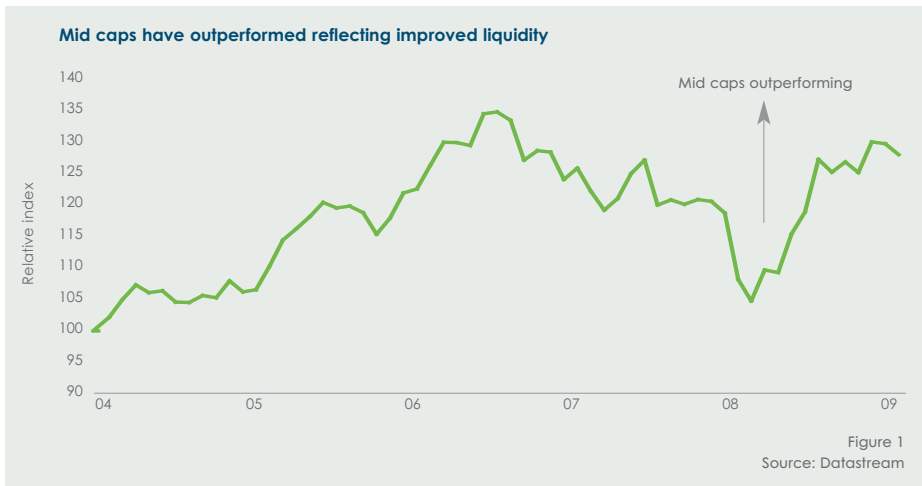
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In our view, the critical factor right now for financial markets is the removal of global liquidity. By reducing official interest rates towards zero and undertaking programmes of ‘quantitative easing’, authorities in the developed world have fuelled asset price rises. It isn’t just equity prices, the stabilisation in house prices, tightening credit spreads and low government bond yields are all a product of excess liquidity being pumped into the system by monetary authorities. The eventual removal of this liquidity (which may begin to occur during 2010) is not necessarily a negative for equities as a whole, but does suggest a significant sea change which will favour some parts of the market over others.

1. Policy: Is the liquidity trade over?

Throughout this crisis there has been an unprecedented amount of liquidity pumped into the global financial system via quantitative easing and incredibly low interest rates. Interest rates look set to remain low for an extended period of time across developed economies. However the focus of financial markets has started to shift towards ‘exit policies’ and how policy makers will respond to a changing mix of macroeconomic data. The issue for financial markets is how policy makers will co-ordinate a winding down of policy stimulus.

Financial markets have been a clear beneficiary of the global liquidity injection. Government bond yields have remained

low despite an apparent recovery in economic data and increase in bond issuance as Central Banks continue to buy Government bonds. This low level of interest rates has also been a positive support for equity markets.

Small and mid cap companies have outperformed large cap companies during the past year, suggesting ample liquidity has driven investors into more risky areas of the market. In our view this is set to reverse as we believe larger cap companies – in particular those paying dividends – should do well as we move into next year.

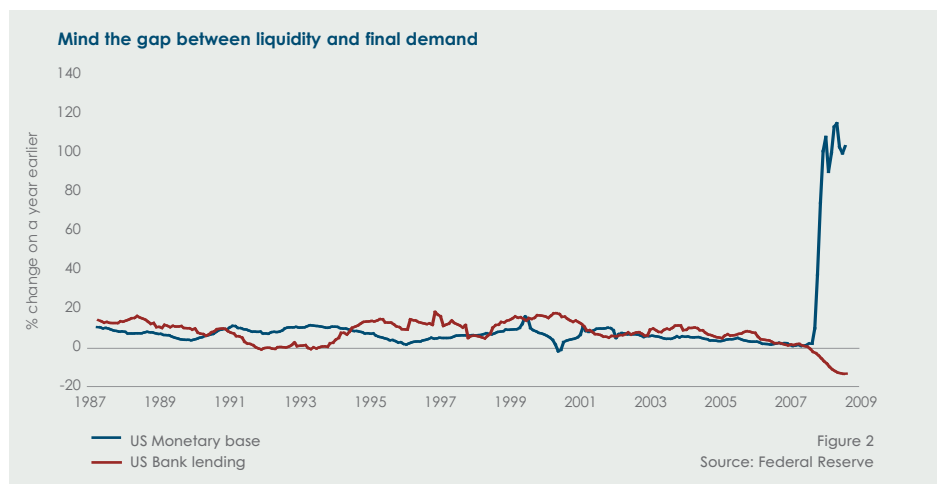
Back in May, policy was still incredibly supportive for financial markets as rates remained low and there was no end in sight for quantitative easing. As a result, the influence of ‘policy’ received a large tick in support of equity market

performance in our models. However, with Central Banks now starting to discuss removing liquidity from the system, we believe significant uncertainty surrounds the influence policy will have on equity markets in 2010.

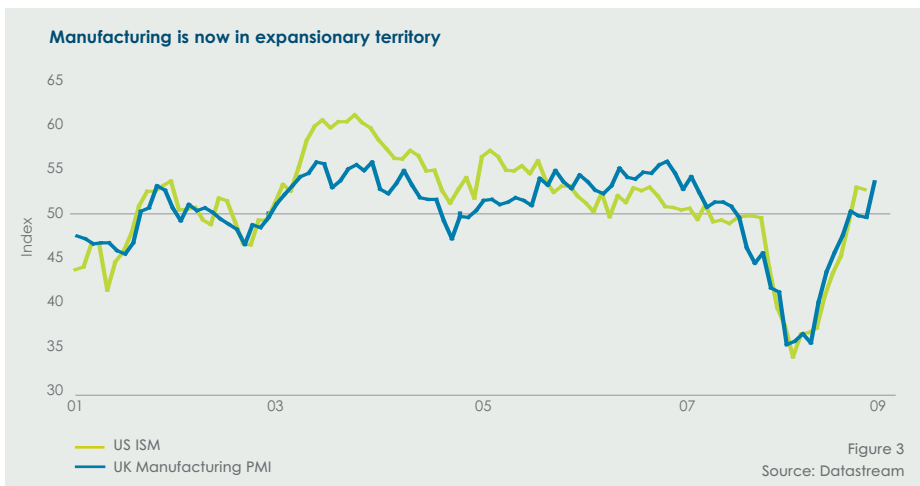
We have already seen tentative signs of global policy tightening with rate hikes in Australia and Norway and some capital controls being enforced in the Emerging Markets. Admittedly, perhaps we can explain these away due to very different commodity related dynamics in these individual countries. However, it has still brought policy tightening to the top of the agenda for financial markets.

Uncertainty

Central Banks have effectively introduced a liquidity cycle during this downturn, which means there is an extra layer of uncertainty for financial markets. The extension of this is the influence on economic growth. A number of commentators have started to talk about sustainable growth. However, how can we be sure how sustainable the recovery really is, when an improvement in growth is emerging at the same time as policy makers continue to increase liquidity? In our view, we can only be sure the recovery is sustainable if growth continues to improve at the same time as liquidity is removed from the global financial system.



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There are two things to consider. The increase in liquidity has not necessarily found its way into the right areas of the economy. From a credit perspective, large liquid corporate bond issuers do appear to have renewed access to capital markets. However, the small and mid-sized companies are seemingly still finding it difficult to access lending. One way of looking at this is to compare the monetary base with bank lending. The monetary base has expanded aggressively, however bank lending remains constrained, suggesting a large part of the economy has still not seen an improvement in credit conditions.

On the more positive side, every cyclical downturn is initially aided by an improvement in liquidity conditions in some shape or form in order to boost economic activity. So in this sense things are no different this time around. Historically, central banks have been able to cut interest rates aggressively in order to boost liquidity and this in turn improved consumer and business confidence which led to a rise in economic activity. This time policy makers have done exactly the same, but a lack of flexibility on interest rates once they reached zero meant they had to boost liquidity through alternative policy measures. We believe this is the reason why equity markets will remain hostage to news flow in the short term, in particular related to whether the economic recovery seen to date is

leading an improvement in final demand globally (i.e. can be sustained) or whether we are at risk from another downturn as we move into next year.

2. Growth: It's getting tougher to surprise markets

Another critical question for financial market participants is whether the economic recovery can be sustained, or whether excess liquidity and the inventory cycle have provided a short term boost which is likely to fade as we enter 2010.

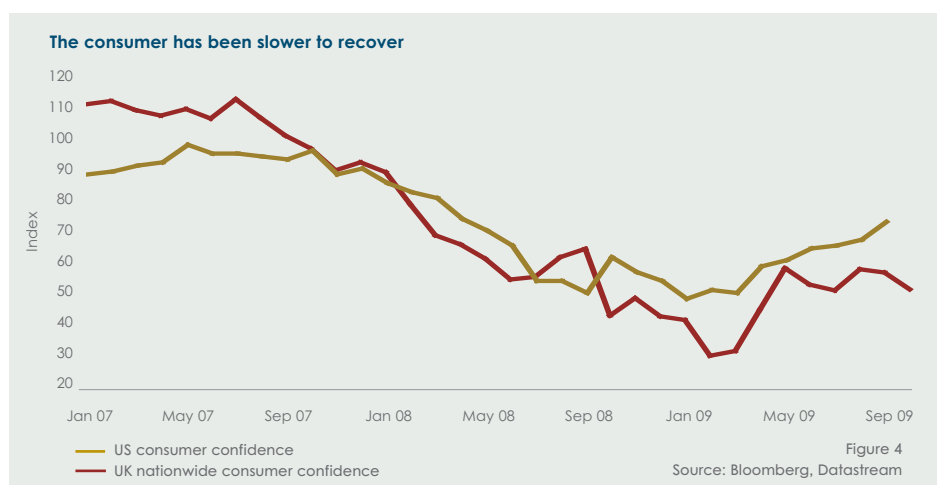
We believe economic growth will remain under pressure as we enter the new year. In particular a structural adjustment surrounding consumers in the developed world will continue to act as a constraint on growth. We anticipate that this adjustment will come as people save more and debt levels are gradually

reduced – see last month's Fundamentals article 'Debt Wish'.

At the same time, the boost to economic activity that has occurred in recent months from factories re-opening and production resuming following the crisis is likely to fade as the corporate sector keeps inventory levels low to reflect the uncertain economic environment – see September's Fundamentals article 'Life After The Recession'.

Two clear themes

In assessing the mix of global economic data, two clear themes emerge; the strength of Emerging Markets versus Developed markets and the manufacturing segment of the global economy versus the consumer. The ISM (Institute of Supply Management) survey in the US gives an indication as to the health of the manufacturing sector. This was one of the first indicators to start to improve at the end of last year. Figure 3 above shows the rapid improvement which has occurred since the beginning of this year, with the current reading now above 50 which indicates economic expansion (below 50 indicates contraction). However, our economists believe this survey could start to stabilise over the next couple of months, suggesting a loss of economic momentum which could prove an issue for the equity market as manufacturing data has to date propped up the recovery thesis. Domestically the UK



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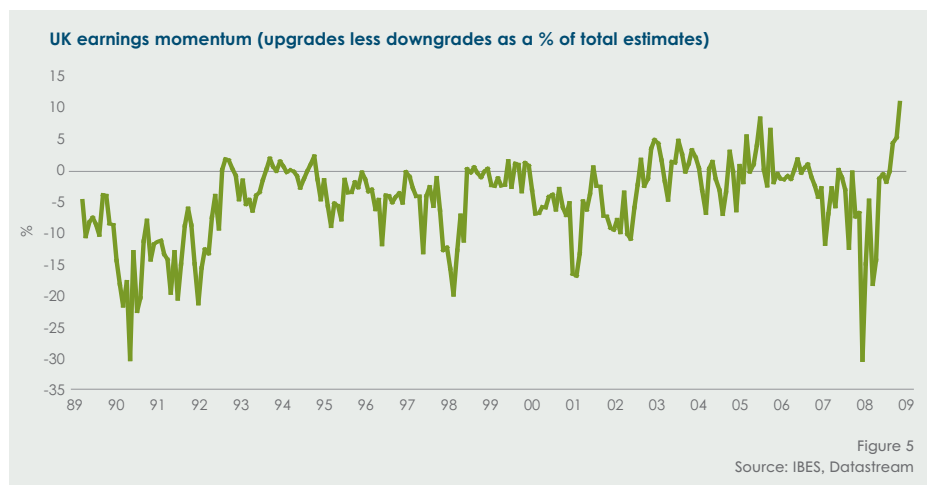
manufacturing PMI (Purchasing Managers Index) has shown a similar recovery and this month moved above 50.

In contrast, consumer data has been lacklustre. US consumer confidence has gone nowhere over the past six months which is a concern considering the recovery in equity markets and signals of a stabilisation in house prices which should have underpinned some improvement in consumer sentiment. However in the UK consumer confidence has started to pick up recently.

In our view developed market economic data will start to lose momentum over the next couple of months. Therefore, we look to the developing economies to underpin hopes of a global economic recovery. Our economists forecast higher economic growth in the developing world versus consensus and so far economic growth in the region has held up well. This implies that at an index level markets are likely to stall as economic data starts to lose momentum in the developed world. However, at a company level it is important to have exposure to those businesses which have revenue exposure to final demand in the emerging markets in order to navigate through a period where final demand in the US, Europe and Japan will likely remain fairly weak.

3. Inflation: No risk for rates but a pressure on margins

The inflation debate is far from over. Headline inflation looks likely to remain subdued throughout 2010 due to a lack of final demand for goods and services and high unemployment continuing to put downward pressure on wages. This is good news for policy as it appears unlikely in our view that central banks in the UK and the US will be raising rates any time soon. Longer-term there is a risk that if policy remains too loose



for too long, inflationary pressures will start to build – but that is more of a risk for 2011 and beyond.

Without higher wages, the potential for higher commodity prices and higher imported goods prices are likely to continue to put pressure on an already stretched consumer in both the US and the UK. We feel this will create lacklustre final demand over the next 12 months. Furthermore, the imbalance in global growth which we expect between developed and developing economies suggests that commodity prices are likely to receive some support from emerging market demand and therefore companies in the West could suffer from higher input costs. Also, in the UK the fall in sterling is not helpful for imported goods prices – potentially acting as a drag on margins through higher input costs.

4. Valuation and 'the cycle'

It is all very well to look at the risks surrounding the macroeconomic backdrop. However, the most important factor for investors is how market participants will value the economic risks which lie ahead. There is a different psychology driving market participants at different stages of the economic cycle and therefore different valuation metrics are more helpful depending on the focus of market participants at any point in time.

During the first phase of a recovery in financial markets, performance is primarily driven by some sort of sign that the economic downturn is ending – a period of hope. Hope over the strength of the profits recovery and an improvement in risk appetite drives markets higher, despite the fact that earnings are still falling. This is exactly what we have witnessed since March this year. A number of forward looking economic surveys, such as the ISM discussed above, started to show signs of improvement and more recently, after analysts cut their earnings forecasts aggressively, consensus estimates are now reflecting net upgrades to earnings forecasts (Figure 5).

The valuation picture earlier this year supported a rise in equity prices as expectations had adjusted downwards and there was room for the market to start to price in some form of economic recovery. Virtually all valuation metrics were at extremely supportive levels for equities, versus long-term averages and previous recessions. As the equity market rally has matured, market participants moved away from valuation metrics and focused on earnings momentum in driving stock price performance. One way of showing this is to look at the change in sector performance versus the change in sector earnings momentum. Over the past month there

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has been an 80% correlation between sector relative performance and sector earnings momentum.

The historic price-to-earnings multiple also reflects this initial period of hope. The market gets re-rated during the first phase of the recovery as equity prices rise but earnings continue to fall. Since March this year the trailing P/E on the UK market has moved from around 7 times earnings to over 12 times earnings.

Can hopes become reality?

This period of hope and initial re-rating of the equity market then transitions into a period of delivery. During the period of hope, growth expectations start to improve. Following these upward revisions to growth forecasts, the market then needs a period in which both economic and earnings data start to satisfy these more optimistic expectations. We alluded to this in our 'Great Expectations' article back in May, suggesting that the next risk for markets was that expectations got revised up too far which would lead to a period of market weakness if economic and earnings data once again started to disappoint.

When valuation multiples were so low back in March it was easier for financial markets to rally on the back of hope over the recovery. Valuation multiples are now closer to longer-term

averages and therefore market participants will need to see evidence of economic recovery before they will be willing to pay a higher price for the future earnings stream. We believe equities will be well supported going into year-end but the sensitivity of markets to new economic data and corporate information has certainly increased, suggesting it is not a one way bet for equity markets over the next six months. We believe that a nimble approach to regional and sector allocations will be critical. The outlook for key economic indicators remains incredibly important in the very near term which then needs to be coupled with the strength of the corporate sector and its ability to continually adapt to a changing macro landscape to maintain profitability.

Some good news for income focused investors

One bright spot for equity investors comes in the shape of dividends. One year ago we were very concerned over the path for dividends. The dividend yield on the market was looking attractive at around 5% however we believed that level of yield was not sustainable. A number of financial institutions had cut their dividends but more was to come from the financials space and other sectors within the market.

Since the end of 2008 the level of dividends for the UK market has fallen by 20%. The largest dividend cuts have come from the financials, travel and leisure and basic resources stocks.

We now believe the majority of dividend cuts are behind us. Payout ratios for companies are low, versus recent history and in particular versus this point in the cycle historically. We now believe earnings will start to recover and therefore the majority of companies will be able to honour their dividend commitments. The dividend yield is now in line with its long term average of 3.5% and therefore is more sustainable than at this time last year. In our view focusing on quality dividend paying companies is an investment opportunity as we move into 2010. On a relative basis this gives support to the higher dividend yield markets globally which are Europe and the UK over Japan and the US.

A sustainable recovery?

We are reaching a critical point for financial markets as policy makers decide how to respond to economic news flow over the coming months. In our view the liquidity trade for risky assets is running out of steam. We are transitioning from a period of hope to a need for delivery as growth expectations have been revised up in recent months. Valuation has moved back towards longer term averages, economic indicators are stabilising, the inflation debate is far from over and policy risk is now hostage to the government beginning to implement 'exit strategies'.

Equity markets will therefore likely pause for breath, analyse the mix of economic and corporate news flow and then take a view on potential long term growth. Financial assets across the board are at risk from a removal of liquidity, and therefore, we feel the important factors to focus on are income, where we now see reduced risk of dividend cuts and exposure to the correct engines of economic growth which remain the emerging market economies.

Market Overview – Equities

Major Equity Markets – Total Returns £ 2008/2009



Figure 1

Source: Datastream, FTSE indices shown

Total return (denominated in £)	October (monthly return %)	Calendar year-to-date (10 months %)
UK	-1.9	17.0
US	-5.2	1.9
Europe	-5.3	9.0
Japan	-5.5	-8.9
Asia	-4.3	36.6

Source: Datastream, FTSE indices shown

The UK equity market succumbed to a bout of profit-taking in October. Smaller to mid-sized companies (by market capitalisation) fared slightly worse than larger companies. These declines mirrored falls in equity markets globally as macroeconomic releases were more mixed particularly towards the end of the month with weaker than expected consumer confidence numbers in the US in particular triggering share price declines. The UK economy shrunk 0.4% during the third quarter, taking market participants by surprise. Most had expected a small increase in growth,

which would have put an end to the recession.

The more defensive sectors of the market such as Beverages and Food Retailers came back to the fore. The main weakness was in Financials, where Banks shares fell in anticipation of another round of equity raising. Corporate results were mixed with positive news from companies such as BP, Standard Chartered and Pearson in contrast to disappointments from the likes of Diageo and Autonomy Company. Earnings releases have now

begun reflecting an improvement in underlying corporate profitability in light of aggressive cost cutting in the second quarter and a boost to demand in the third quarter from the inventory cycle and demand from emerging economies. However, we do not believe equities will remain on an upward trajectory over the next six months without some form of setback reflecting a re-pricing of the ongoing pressures on final demand. Unemployment is likely to remain relatively high and the withdrawal of government stimulus means that the economic recovery is likely to be relatively subdued which will ultimately put pressure on corporate profitability. As a result, equity markets will likely endure a period of weakness to reflect this more subdued economic backdrop.

Fixed Income

In the US, we believe the unemployment rate will probably stabilise around 10% and then start to fall later in 2010. However, the large pool of unemployed workers will continue to put downward pressure on wages. Furthermore, we believe that weak consumer spending growth will limit the ability of service sector companies to raise prices. We see inflation falling below target in the UK and the Euro-area with Japan mired in deflation.

In the absence of a sustained period of above-trend growth and a substantial fall in unemployment we see little prospect of interest rate increases in 2010. A final reason for expecting exceptionally low interest rates to continue for some time is that the boost from fiscal policy should fade through 2010 and in some cases could become contractionary. If governments are cutting spending or raising taxes, there will be less need for central banks to restrain growth. As a result, central banks are likely to keep

official interest rates on hold, potentially until 2011.

Given the considerable uncertainty over the outlook for the global economy and corporate earnings, volatility in credit markets has remained at elevated levels. Lower-rated issues have been among the

leading beneficiaries during recent months. Despite 2009 year-to-date global bond defaults recently soaring to top previous full-year levels, demand for high yield credit has remained strong.

Major Bond Markets – Total Returns £ 2008/2009

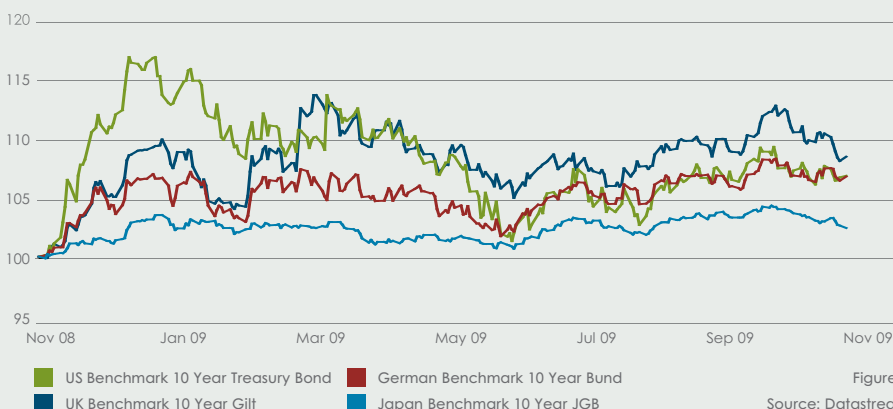


Figure 2

Source: Datastream

Snapshot

Has global manufacturing confidence peaked?

The recovery in financial markets since the spring has coincided with an improvement in global manufacturing activity. This is not unusual. It tends to happen in every economic cycle, including the 1930s. We anticipated the recovery in manufacturing activity and financial markets because we thought factory output was unsustainably low. We now think the manufacturing recovery could fade and this could temper the rally in financial markets. This is because US manufacturing inventories now appear to be rising rather than falling.

At the start of the year many companies temporarily closed factories to trim excessive inventories of unsold goods. This plunged the US economy into a sharp recession. As production fell below sales, inventories began to decline. But eventually production had to recover, even if sales continued to drift lower, because inventories would eventually run out. This recovery in production duly happened. Official data show that three consecutive monthly increases in industrial production saw the US economy grow at an annualised rate of 3% in 3Q09.

While production should continue to rise rapidly in 4Q09, we believe the economy could slow as we head into 1Q10. This is because the level of production appears to have caught up with sales. So from now on, production is unlikely to grow faster than sales and we remain concerned that sales will only rise at a modest pace.

Survey data suggests manufacturing inventories are rising again



Figure 1
Source: Reuters Ecowin, LGIM estimates

Figure 1 illustrates our concern. The inventories balance of the monthly manufacturing survey from the Institute of Supply Management (ISM) rose above its long-term average in October. This suggests inventories are now rising rather than falling. While it is possible that the level of inventories is too low – so firms will be happy for inventories to rise for a while – the pace of production gains is likely to slow from here. This would be consistent with a moderation in the headline ISM survey which financial markets focus on. We anticipate it slipping back towards the 50 'breakeven' level in 1Q (Figure 2). This might disappoint investors looking for further sharp improvements.

Our forecasts suggest manufacturing confidence will falter in 1Q10

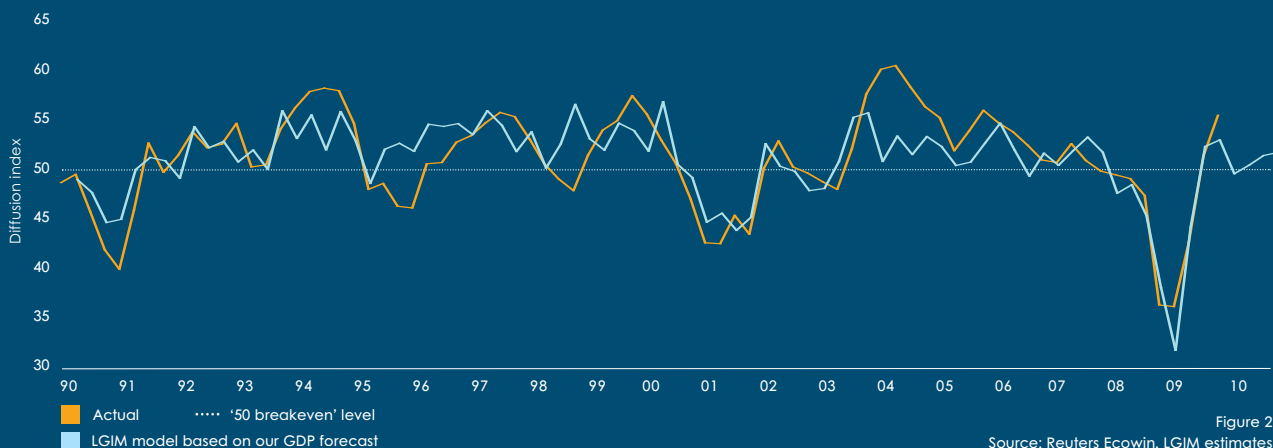


Figure 2
Source: Reuters Ecowin, LGIM estimates

UK Forecast

A period of subdued growth ahead

UK Economy		Price Inflation (HICP)		GDP (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro	
		2009	2010	2009	2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010	End 2009	End 2010
Market participants forecasts		%	%	%	%	%	%	%	%				
	High	2.60	2.40	-4.20	1.70	4.10	5.00	0.50	2.50	1.85	1.86	0.98	1.03
	Low	1.90	1.30	-4.50	0.70	3.30	3.40	0.50	0.50	1.52	1.36	0.87	0.76
	Median	2.10	2.05	-4.40	1.10	3.75	4.60	0.50	1.25	1.63	1.68	0.92	0.85
	Last month median	2.00	2.00	-4.25	1.25	3.95	4.60	0.50	1.25	1.66	1.69	0.89	0.85
Legal & General Investment Management		2.20	2.40	-4.60	1.90	4.00	4.50	0.50	0.50	n/a	n/a	n/a	n/a

Source: Bloomberg and LGIM estimates

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.

We believe we are about to enter the final stage of a square-root shaped economic recovery. After the sharp downturn, economic data began to improve mid-way through this year as, following extreme cost cutting, factories reopened and begun rebuilding their inventory levels to respond to increasing demand.

However as we head into year end, we believe growth will begin to flatten off as support from government begins to fade and rising energy prices continue to squeeze people's real incomes.

We revised our GDP forecasts for the UK economy slightly lower this month. We now anticipate growth for 2010 to be 1.90% rather than 2.10%. We remain far more optimistic on growth than the median market participant (consensus), however, who predict growth of only 1.10% next year.

The relatively subdued period of growth we anticipate next year is likely to keep unemployment high. This should continue to apply downward pressure on wages and therefore core inflation. We do not believe the Bank of England will withdraw their quantitative easing programme nor are they likely to extend it in the medium term. We anticipate official interest rates remaining on hold through 2010.

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