

Return to Sender

According to reports, the Fed's decision to cut rates on 18 September has let the genie out of the bottle. The Fed is debasing the currency. We will now see rising inflation, a collapse in the dollar and a boom in the price of gold, they say. But, as Albert Einstein stated 'Theories should be as simple as possible, but no simpler'. And we suspect that the prevailing theory is just a bit too simple. So, in order to try and answer the question, 'Where are we going from here?' we thought the best starting point would be to ask the question, 'How did we get here in the first place?'

And the best place to start this story is Alan Greenspan and his infamous conundrum. As the Maestro describes in his book, something very strange took place in world financial markets in the second half of 2004. 10-year bond yields did not rise as they normally do during a Fed tightening cycle. Instead, they fell.

Greenspan reports that he asked the key Fed officials, 'What the heck is going on?'. And the reason he paid so much attention to the issue was that, if it continued, it meant that he, and in consequence the institution that he represented, was no longer the most powerful force in the market. Something else was. Greenspan noted that the Fed started to raise rates in June 2004 to take some of the froth out of the housing market. But as mortgage rates actually fell over the period, the opposite happened. The housing market went wild. And as Robert Schiller described in an excellent paper delivered at Jackson Hole this year, we saw an unprecedented housing boom, in breadth as well as in magnitude, across US states, and across countries. We have never seen anything like this before.

Now, as is Greenspan's wont, this got him thinking. And the first issue he thought of

was globalisation. And in particular, its impact on productivity growth. The key point here is that, since the fall of the Berlin wall in 1989, and the coincident market reforms in China, in India and across other emerging markets, around two billion new workers have joined the global, capitalist workforce. The initial impact – felt through much of the 1990s – was deflationary. This was because productivity levels were so low – particularly in the military base of the Russian and Baltic states, and the cost of capital was so high, that demand and production simply collapsed. Resources that previously fed that demand were diverted to the West. We saw a slump in the price of those resources – from aluminium to oil. And this was exacerbated by the Asian – or more accurately – emerging markets crises of 1997-1998.

Moving into 2000s something changed – productivity growth rose, and the cost of capital fell. Not only were the BRICs (Brazil, Russia, India and China) catching up with Western production standards, they were making money from it as well. And that became self reinforcing. But, for Greenspan, it was the speed of the productivity growth that mattered. Key to this are the 40m Chinese migrating from



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the land to the cities each year. Typically, workers will see their productivity treble as they migrate. And those 40m people represent 1% of the global workforce. That migration alone is adding 2% to global productivity growth. And if you add another 40m people raising productivity worldwide by emigrating (from Eastern Europe), or migrating within other developing countries, you are potentially talking about a doubling of global productivity growth. And that has a tremendous impact on inflation. Companies can withstand a lot of raw material and wage cost pressure and still remain profitable with productivity growth like that. So bond yields can be lower for any given level of global growth and resource constraint.

The credit for the second key insight must go to Ben Bernanke, who described a 'savings glut' in emerging markets in a seminal speech in 2005. Emerging market authorities had changed their spots since the financial debacles of the 1980s and 1990s. They were using their new found profitability to pay down debt. And they were using their ballooning reserves to buy foreign debt, predominantly US debt. And as Warnock and Warnock, two Fed staffers, proposed – that could account for 10-year yields staying up to 100bps below their 'fair value'.

Now Bernanke's analysis of the Emerging market authorities could apply equally to developed world corporates. After the investment debacle of the late 1990s,

corporates and their shareholders had only one thing in mind from 2002 – maximise their cash flows. Restructure, cut capital expenditure, stop hiring, whatever, just maximise cash. As the recovery progressed, the improvement in corporate cash flows was truly awesome. Unfortunately this cash went back to shareholders, rather than into capital expenditure. Moreover, perverse regulatory requirements in the UK insisted that insurance companies reduce risk by investing in bonds and credit, ensured that the cash generated by equities was siphoned off into bonds. Another powerful contributor to lower bond yields.

Now, this is where the story gets interesting, because these low bond yields fostered perhaps the greatest global credit boom of all time. A credit boom that, Greenspan admitted, grew to greater proportions and became more complex than the Fed and its sister central banks could properly comprehend.

Now, rather than add to the descriptions of the acronym laden world of credit and credit derivatives, and the strange fauna that lurk therein, I would rather discuss the impact that credit has had. And that requires a trip to Austria.

The Austrians have an unusual take on inflation. It's not the change in the level of consumer prices; it's the growth of credit. The growth of credit, they say, should match the potential growth of the economy. If credit growth runs too fast, then asset prices will rise relative to

incomes. And if that happens it will induce a misallocation of capital – it will induce capital to produce non-productive assets at the expense of productive ones. The next insight belongs to Friedrich Hayek – once credit growth has grown faster than GDP for a sustained period, and asset prices have risen against wages, then credit needs to continue to accelerate – or else the economy would display 'recessionary symptoms'.

The interesting thing about the Austrian take on credit is that it appears nowhere in the traditional models of the Fed or the broad swathe of market practitioners. Yet, at times, it seems to fit the facts.

A cursory analysis of the US housing market would appear to support the argument. From 2002 US long term rates remained below the norm. This saw an exceptional rise in house prices to 20% above the long run relationship with GDP/capita in the US. That in turn led to an aggressive increase in the returns on house builders, whose shares rose tenfold from early 2001. Housing output increased aggressively. And the process of collateralisation and selling on the mortgage debt set off a virtuous circle. Banks typically repackaged and sold on around 75% of the mortgages that they originated. 50% to the US mortgage enterprises, Fannie Mae and Freddie Mac, 25% to the investor market (hedge funds, CDO managers or their own SIVs and conduits). 25% they kept on their own balance sheets.

The strong demand for these products raised the value of the loan assets – and expanded balance sheets, this enabled more lending. Origination of mortgage and asset backed securities also became a highly profitable activity in its own right. But as the products appreciated, yields fell. The originators hunted for yield further down the quality spectrum – issuing a range of more 'innovative' products such as no document teasers, adjustable rate mortgages (ARMS) and the like. This led to a boom in the banks' willingness to lend, which in turn enabled a broadening of

CHANGE IN THE US TRADE DEFICIT

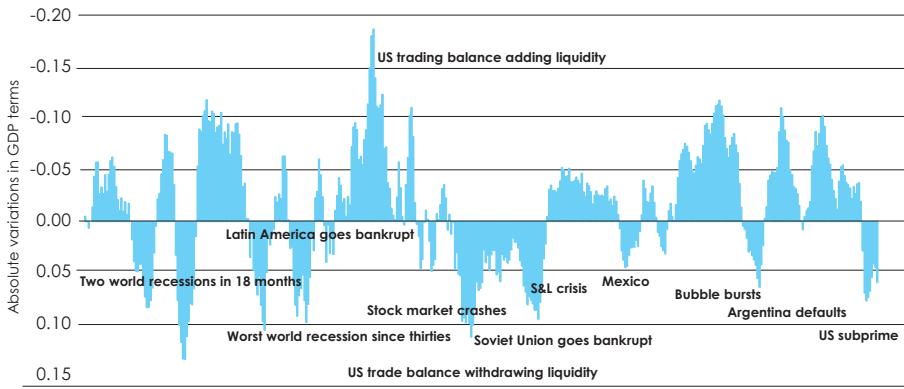


Figure 2 Source: Reuters EcoWin, Gavekal

borrowing activity – with 120% mortgages and so on. Mortgage yields fell and house prices rose, which reduced default rates. This in turn fed through to further compression of mortgage spreads, and a greater demand for riskier mortgaged backed securities. And so it went.

Then in 2005, Susan Bies, the Fed Governor in charge of banking regulation insisted on controls on some of the more extreme lending practices, in the interest of financial stability. She did not mandate a change in practices, but she used moral suasion, and she induced a firm expectation that regulation would tighten aggressively if the lenders did not change their behaviour.

That marked the peak in growth of mortgage lending. House building stocks rolled over at the same time (Figure 1). The housing market topped out a year later. And, indeed, it appears that the deceleration in mortgage credit creation has, with a lag, created ‘recessionary symptoms’ – for the housing market, for related physical service industries, and now for the owners of the loan assets.

But the deceleration in credit growth in the US housing market did not mark the peak in global credit growth.

That peak has yet to show up in the data. What is truly extraordinary is that global liquidity continued to rise in spite of a sharp tightening of liquidity stemming from the US. US narrow money supply was

growing more slowly than GDP. And the US current account deficit was shrinking fast for most of the past year (Figure 2). Both are signals that there are fewer dollars available for foreigners to borrow. Such rapid changes in the availability of dollars have typically led to financial debacles, as the dollar borrower with the weakest credit quality has collapsed.

This time, the process took longer than usual. It took until August 2007 before the real strain began to show. The best indication of global liquidity is probably foreign central bank reserves (Figure 3). This measure of liquidity diverged very aggressively from the move in the US current account deficit, and US money supply, over the past year.

Why did this happen? In our view this was the result of the aggressive expansion of credit driven, in part, by the

securitisation and disintermediation boom. A disintermediation boom that involved the setting up of sponsored off-balance sheet ‘Special Investment Vehicles’. But it also happened as local companies and individuals borrowed from overseas banks – something we’ve seen from entities as diverse as Chinese real estate developers to Latvian mortgage borrowers. The problem with monetary analysis is that it is very hard to track liquidity once it ‘goes off the balance sheet’. The only way is to measure where it ends up – in foreign reserves.

Our impression is that the collapse in securitisation and disintermediation, and the Banks’ sharp reduction in lending activity during the current commercial paper market squeeze will lead to a marked contraction in reserves. This combined with a reduction in surpluses as the oil exporters divert supplies to domestic use, and then import capital goods as they build out their domestic infrastructure.

The key issue is whether foreign reserve growth falls below nominal global growth. If it does, it tends to disrupt asset markets, and ultimately slow global growth.

Why is this analysis of global liquidity important? First, because it is little analysed and as Humphrey B. Neill suggested in ‘The art of contrary

CHANGE IN FOREIGN RESERVES

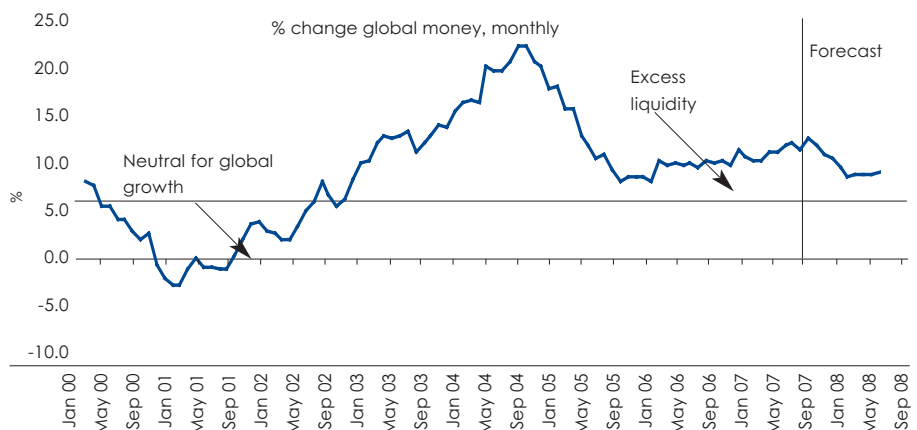


Figure 3 Source: LGIM, Federal Reserve

thinking’ – when something important is largely ignored, it tends to prove much more important than the market appreciates.

How so? To answer this we have to go back to the Austrians. We would argue that the same analysis applies to the developed world financial corporations. As assets have risen faster than incomes over the past 25 years – capital has increasingly flowed into financial engineering, at the expense of physical engineering. According to the Austrians, this misallocation should cause returns on financial engineering to fall, especially relative to ‘real’ engineering. A quick glance at the share prices of engineers versus banks will tell us that this is exactly what has happened.

Hayek’s final point, that a deceleration in credit growth will generate ‘recessionary symptoms’ is yet to be proven for the broader US economy. But the mechanism is certainly in place – the credit events of recent weeks will likely reduce the willingness and ability of the banks to lend, and it will reduce the willingness and ability of corporates to borrow. That will sap consumer and corporate confidence as the banks balance sheets are now stretched, and induce a slowdown in US activity.

But all is not gloomy. The emerging economies now have returns well in excess of the cost of capital (Figure 4). And that, in turn, has created a major feedback loop – spurring reflationary investment.

But the investment has been relatively slow to materialise (as we highlighted above – more investment has fed into financial engineering than physical engineering). That, in turn, suggests that there is potential for returns in the emerging markets and among their suppliers, to remain elevated, and to outperform developed world returns for a sustained period. So the common question in markets is ‘Can the rest of the world decouple from a slowing US?’ Perhaps the question should be ‘Can the

US decouple from a booming world?’ On the prospects for emerging economies, I would like to highlight where the risks have risen, because they have risen.

The key risk for us is not inflation but the interaction of the credit cycle with energy prices. High energy prices typically drain spending power from the US consumer, but easier credit (including the reflux of capital from the oil exporters) combined with rising incomes, ensured that the US consumer stayed afloat over the past five years.

If capital is now ‘returned to sender’ and emerging markets take over the reigns of global growth, then we may have a problem with commodities, because of intensity of use. US GDP has more than doubled from 1982, but it weighs exactly the same as it did back then. Chinese GDP has doubled since 2000, but it weighs three times as much. China uses much more oil and much more copper per dollar of growth than the West.

Now, this is particularly important in energy, where supply has become unresponsive to rising prices. Exporting nations have reduced exports for three main reasons. Mexico, Norway and the UK have seen production decline for geological reasons. Nigeria, Iraq and Venezuela are struggling to increase production because of domestic strife, or insufficient investment. And Russia and the Middle East are growing consumption twice as fast as production, leading to slower export growth.

The problem comes if the rising intensity of oil use bumps into the falling price sensitivity of supply – leading to an uncontrolled rise in oil prices. This is no idle speculation – look at the behaviour of lead or wheat in recent weeks. Under certain conditions, conditions not unlike those prevailing today, commodity markets can become unruly. If the ongoing demand for energy from emerging markets leads to an outsized rise in prices it will undermine an already weak US consumer, and it could thrust the US into recession. The key issue is speed. If oil prices rise quickly, the impact on US consumer spending will be swift. This negative impact will be front-end loaded. It will take more time – typically two years – for spending or reserve redistribution in the oil producing states to pick-up.

Conclusion

Now, it appears that the misallocation of capital is creating deflationary pressure via the banks – but inflation in the energy complex. That suggests that the misallocation of capital will throw sand in the wheels of the ‘natural state of capitalism’ – the deflationary boom. Instead, the rather more unpleasant state of affairs – sogflation (soggy growth, but continued inflationary pressure) – will likely result in the US, while Asia booms. But we must recognise, that while this outcome would not be a bad one for asset prices globally, the risks have risen that conditions could become more difficult, should commodities rise sufficiently high and sufficiently fast.

BRICS COST OF CAPITAL VS. NOMINAL GROWTH

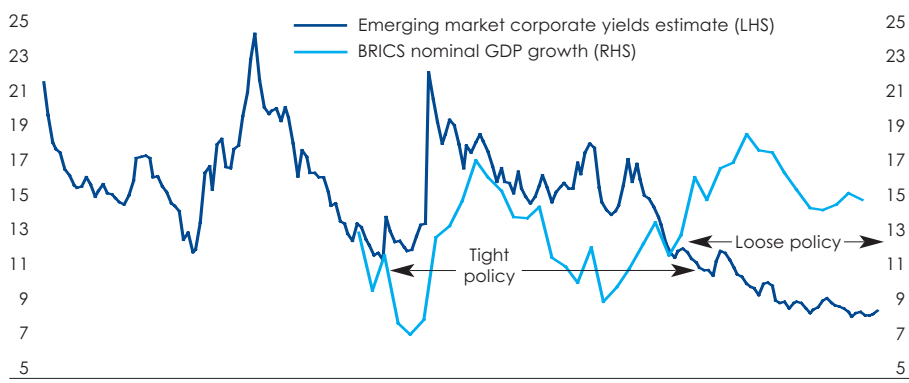


Figure 4

Source: LGIM, Bloomberg

Market Overview

Fed works its magic and turns Bears to Bulls

September saw the Federal Reserve cut its target interest rate by 50 basis points to 4.75%. This move gave the markets a blast of dynamite and they accelerated away from the lows and back to the previous record highs seen just before the credit crisis. The cut in the base rate hurt the dollar and it slumped on the foreign exchange markets, except against the Yen where it gained as the carry trade was placed back on as investors returned their risk to the financial markets. Commodities had the biggest monthly gain in 32 years as the dollar's slump enhanced the appeal of energy, grains and precious metals as a hedge against inflation.

The August US employment data was the first decline in the data for four years spurring speculation that the credit market problems would end the US expansion. This was until the September figures were announced along with a large upwards revision to the August data wiping out predictions of a recession and giving another push to the stock markets and reducing expectations that the Fed would reduce rates again at its next meeting.

London

Bank saving banks

The UK equity market generated a positive return of 1.9% in September. The FTSE 100 index rose 2.6% whilst mid and small cap indices fell by 2.2% and 1.7% respectively. Mining and Resources stocks dominated the leader board as commodity prices rose sharply. Defensive sectors such as Telecoms and Utilities also performed strongly. Conversely, Financials and Consumer Discretionary sectors such as General Retail and Leisure were weak as the market worried about the impact of an economic slowdown. The dominant corporate event was the rescue funding for Northern Rock from the Bank of England. Elsewhere, Tate and Lyle delivered another profit warning whilst Wolseley produced a downbeat assessment of future profits. On a more positive note profits from Next and Carnival both beat market expectations and BG Group announced a significant oil discovery in Brazil. We maintain a positive long term view on the UK equity market although we expect further volatility in the short term.

Wall Street

Rally but weaker earnings forecast

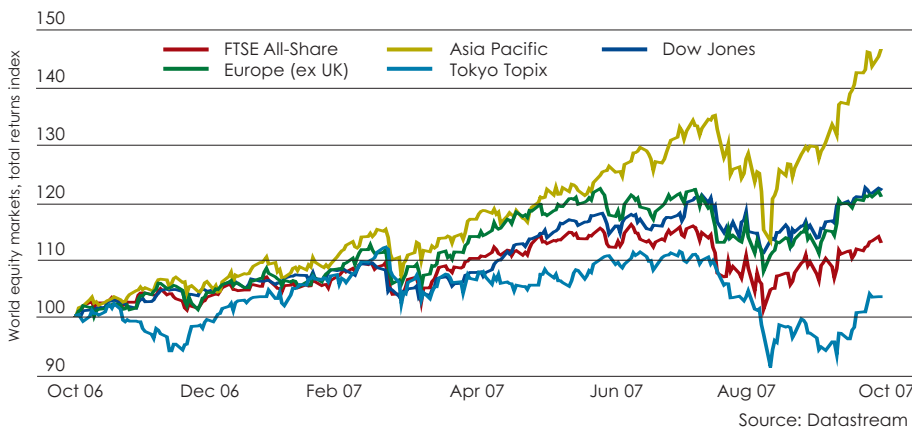
The S&P 500 rallied 3.5% in September and hit a new all time high during the month. The Federal Reserve eased monetary policy by lowering its key rate to 4.75%. This move helped spur optimism that the U.S economy can avoid a prolonged and serious downturn. Energy, materials and industrial stocks lead the gains as investors sought exposure to international growth.

Housing market data showed continued deterioration. An index of nationwide house price declined 4% year on year. Retail sales and consumer sentiment data also came in weaker than expected.

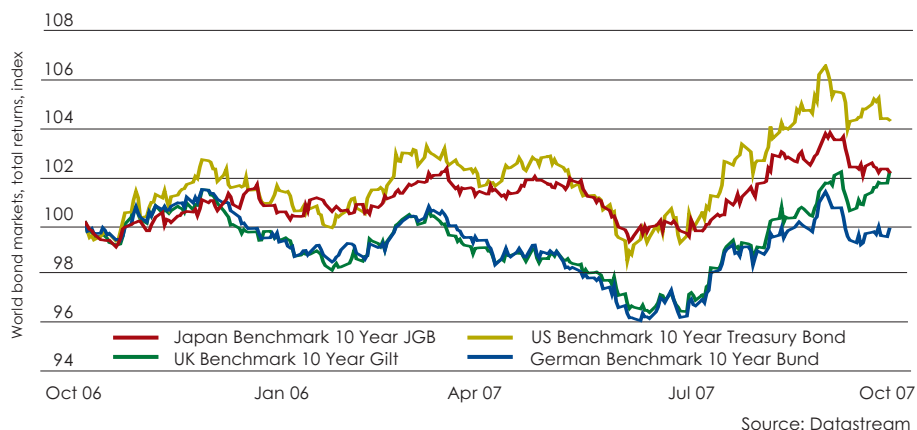
Lehman Brothers, Goldman Sachs and Morgan Stanley disclosed the impact of the credit meltdown on their operations. The firms lowered fixed income revenue expectations and wrote down the value of Leverage Buy Out (LBO) financing commitments. Target Corp (retail) lowered its September sales forecast due to lower customer traffic trends.

Looking forward with equity markets at new all time highs, investors are eagerly awaiting third quarter earnings. Q3 analyst estimates have been cut significantly and cuts to 2008 estimates may be needed before the year is out. While US GDP growth is expected to remain tepid in the near term, emerging markets should continue to generate robust growth. Investors have therefore favoured companies with above average international exposure. The decoupling of US and emerging market GDP growth is critical to the outlook for profits.

MAJOR EQUITY MARKETS – TOTAL RETURNS £ 2006/2007



MAJOR WORLD BOND MARKETS – TOTAL RETURNS £ 2006/2007



Europe

Uncertain outlook for banks

The 50 basis points cut in US interest rates provided the catalyst that turned markets around in September. Having been down for most of the month, European equities finished September in positive territory, rising by an aggregate 1.4% in euros. In addition, with interest rates in Europe remaining static, there is the justifiable perception that European interest rates will not decline as rapidly as they will across the Atlantic; this has led to noteworthy currency strength, with the euro rising nearly 5% against the dollar during the month.

Around Europe it has been the financial stocks that have been in focus, with the mortgage banks struggling in particular. The worst performers in the decline have been those banks most highly-geared to the weakness in domestic property markets, such as the Irish and the mid-cap Spanish banks. In these countries real estate and construction have been booming in recent years, funded by low interest rates set by the European Central Bank. With rising interest rates out of the control of domestic policymakers and wholesale funding drying up the pace of decline in housing activity and prices has been dramatic. Even though these stocks have bounced following the US rate cut, the outlook is far from certain, with activity continuing to decline.

In the final quarter of 2007 it will be the trade-off between monetary policy and underlying economic activity that determines the direction of equity markets. Across Europe activity is still comparatively healthy, with domestic economies in northern Europe especially performing well. In addition, the rapid growth of

emerging Asian countries, obviously led by China, and the ongoing emergence of Eastern Europe is providing a healthy source of demand for industrial companies in Europe. Set against this is the headwind of a stronger euro and the weakness in peripheral markets. Ultimately we believe it will be the comparatively low valuation of stocks and the relative attractions of equities against other asset classes in an environment of easing liquidity which should push markets higher.

Japan

Carry on: exporters rally

The Japanese markets have rallied alongside global markets since rates were cut by the US monetary authorities. However, in contrast to the US, the Japanese index has some way to go before reaching a new high for the year. Investor risk appetite has once again returned leading to a reversal of the sharp appreciation seen by the Yen versus all major currencies prior to US monetary loosening as investors once again build carry-trade positions. Another beneficiary of rising risk appetite is the smaller cap market in Japan, which has seen its first meaningful rally since early 2005. Exporters rallied, although there has been notable out performance by those companies more geared into Asian growth, particularly China, traditionally US focused exporters have lagged on lingering doubts over the momentum of US economic growth. Domestically there has been little change in the economy and focus is returning to earnings as we approach the interim reporting season.

Pacific Basin

Climbing up a wall

In September the FTSE AW Asia Pacific Index performed strongly rising 11.5% in sterling terms, investor sentiment much improved after the US Fed cut the federal funds rate by 50bp to 4.75%.

FTSE W China surged 18.6% and FTSE W Hong Kong rose 14.1%, both markets driven by a flood of liquidity encouraged by the success of QDII (qualified domestic institutional investor) funds launching in Hong Kong. China Southern Fund saw US\$ 6.5bn subscription on its first day suggesting a strong demand for such products. The shares of Hong Kong Exchange surged 83% after the Hong Kong government increased its holding in the exchange to 5.9% and rumours that Chinese State funds were building a stake. India had a strong month rising 14.9% underpinned by around \$1bn in net foreign inflows. Australia was up 13.2% driven by energy and commodities. Laggard markets were Taiwan up 4.9% (where the CBC hiked interest rates by 12.5bps to curb inflation) and Thailand up 4.1%.

Despite the risk of a near term correction given the swift rebound from the August lows, it is likely that investors climb "a wall of worry" with markets rising into year end. The start of a Fed easing cycle, cautious investor positioning and a Hong Kong China Initial Purchase Offering (IPO) frenzy point to further strength in the final quarter of 2007.

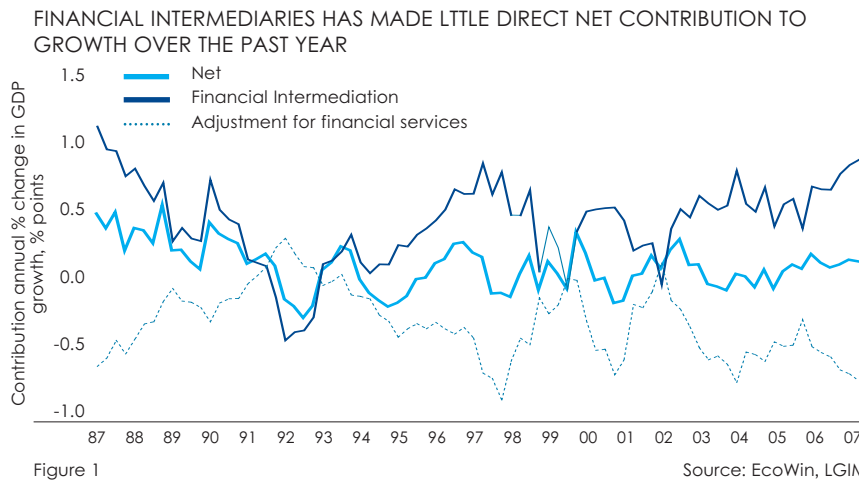
Investors will closely monitor the quality of earnings results, policies emanating from China's 17th National Party Congress starting mid October and ongoing developments in the US economy. Furthermore as net trade accounts for only 8% of Chinese GDP with some strategists believing that a US recession would only trim 2% off Chinese GDP growth and that Chinese growth will continue to support Asia.

Snapshot

City limits

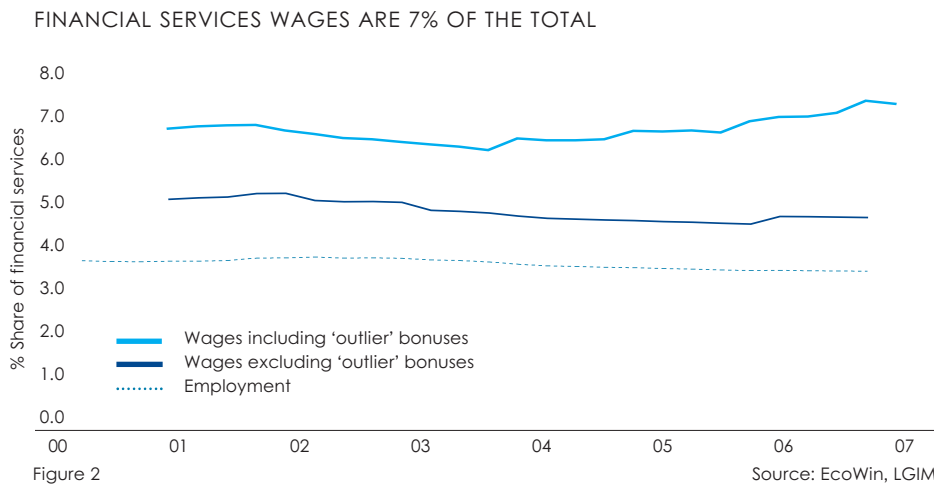
How severe is the impending economic downturn? An old joke can give us a guide. "When your neighbour loses his job, it's a slowdown. When you lose your job, it's a recession. When an economist loses his job, it's a depression". Given that economists are rapidly revising down their growth forecasts, is it because the economy is genuinely under pressure, or because the mortgage securitisation department at the investment bank they work for has just destroyed the bonus pool?

Many economists are worried about the impact of weaker financial services activity on the UK economy. It accounts for around 7.9% of GDP and has grown by more than 10% over the past year, suggesting it has accounted for 0.8% of the total 3.1% growth recorded in the whole economy (Figure 1). If a sustained credit crunch freezes up debt-financed transactions, many fear UK activity will slow sharply.



We're less concerned. As Bank of England deputy governor John Gieve recently said, the UK economy doesn't currently adequately measure financial services activity. There is an equal offsetting drag on growth called "adjustment for financial services". Once we take this into account, we estimate financial services activity has boosted UK growth by just 0.1% over the past year.

But while there is unlikely to be a sudden direct effect, we can't rule out indirect problems. People in financial services could lose their jobs and receive lower bonuses. We shouldn't be too worried about the employment effect. Financial services employment has actually been contracting since 2002 due to outsourcing and the rise of the internet. Indeed, the share of financial services workers in total employment peaked at 3.8% in 1991 and is just 3.3% now (Figure 2). But workers in financial services earn more than the average so their share of wages and salaries is greater than this. If we include 'outliers' (that is companies paying exceptional bonuses that are normally excluded from the average earnings index), financial services workers account for just under 7% of total wages. Weaker bonus payments will depress this. But the impact on consumer spending might be less than the impact on tax receipts and the housing market. Richer people are higher rate tax payers and they save more of their income than poorer ones. And in recent years, people have preferred to save by investing in property rather than equities.



Views Commentary

Earnings get hit

	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	2.08	2.07	0.70	0.72	7300
Citigroup Smith Barney	-	-	3.00	2.30	5.40	8.80	5.09	5.48	5.50	5.25	1.99	1.99	0.71	0.72	6800
CSFB	1.80	2.10	2.80	2.20	7.80	7.80	4.80	4.75	5.50	5.25	1.96	1.83	0.72	0.73	6800
Deutsche Bank	2.30	1.80	2.90	1.90	6.30	8.80	5.00	5.00	5.75	5.25	2.01	1.90	0.72	0.74	7600
Goldman Sachs	1.80	2.10	2.80	1.80	3.80	11.10	4.50	4.90	5.75	5.00	2.05	2.05	0.68	0.70	-
HSBC Securities	1.70	1.60	2.40	1.80	7.00	4.00	4.80	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	5.20	-	5.75	5.50	2.10	1.90	0.67	0.71	-
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	2.40	1.90	3.00	2.20	7.00	8.50	-	-	5.75	5.25	2.06	1.84	0.68	0.70	7151
Morgan Stanley	2.20	2.10	2.80	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	2.90	2.00	6.20	7.40	5.04	5.20	5.75	5.50	1.99	1.91	0.69	0.69	7100
Median (ex L&G Inv Mgt)	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
Last Month	2.80	2.45	2.80	2.35	6.75	7.00	5.20	5.30	5.75	5.50	1.99	1.91	0.68	0.70	n/a
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 2007, not a point forecast.

LGIM has revised down its forecasts for UK growth and interest rates next year, reflecting tighter global credit conditions. But it still expects UK growth and interest rates to hold up better than consensus due to the positive influence of resilient emerging markets and increased fixed rate mortgages. We have more modest stock market returns than consensus because we believe higher interest rates and weaker profits than consensus expects will subdue markets.

Respondents to our survey have for the second month in a row revised down the 2008 base rate forecast. It is now expected to be 5.25%. Bond markets continue to be affected by liquidity troubles and in response respondents have reduced their estimates for yields in 2007 and 2008.

Earnings forecasts for 2007 have been revised down as many financial companies put the loss from their sub prime units on to their books reducing profits. But respondents expect 2008 earnings to bounce back as companies recover from the credit crisis.

Trouble in the UK with Northern Rock has caused sterling to weaken with respect to the euro. In respect to the dollar it is expected to fall back in 2008.

For further comment on Fundamentals, or for additional copies, please contact Harriet Moore at harriet.moore@lgim.co.uk
For all IFA enquiries or for additional copies, please call 0845 273 0008 or email cst@landg.com

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www.lgim.com

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