

Taking stock: The equity market recovery?

Back in May, Legal & General Investment Management's (LGIM) Investment Strategist, James Carrick, flagged the possibility of a UK recession. Last month we heard the Governor of the Bank of England (BOE) forecast 'no growth' for the next year. Yet, despite the economic doom and gloom, stock markets tend to be forward looking. Waiting for things to get better, therefore, may mean missing out on strong equity market returns. In this edition of Fundamentals, James Carrick identifies the four key factors which could support an equity market recovery – and when we are likely to see them fall into place.

Recovery in 2009?

We have been cautious on equities for more than a year. In particular, we have been concerned that the global economy was overheated (running above full capacity). This led us to believe a severe economic downturn was necessary to control inflation.

We have identified four factors that would make us positive again: cheap valuations, low inflation, loose global monetary policy and an improvement in growth. At present, valuations seem attractive and the current economic downturn appears

severe enough to contain inflation pressures, allowing central banks to loosen policy. But until banks become willing to lend again, corporate profits are likely to continue to be disappointing. The bottom line is that the bear is unlikely to leave the market until the second half of 2009.

Although the Federal Reserve (Fed) slashed interest rates to offset the credit crunch, the European Central Bank (ECB) continued to tighten policy. Indeed, 44% of the world's central banks have raised interest rates over the past six months (Figure 2). We simply cannot see this

Signals for a market recovery

	Now	First half of 2009	Second half of 2009	2010
Valuations	✓	✓	✓	✓
Low Inflation	✗	-	-	✓
Loose Monetary Policy	✗	✓	✓	✓
Economic Growth	✗	✗	-	✓

Figure 1
Source: LGIM



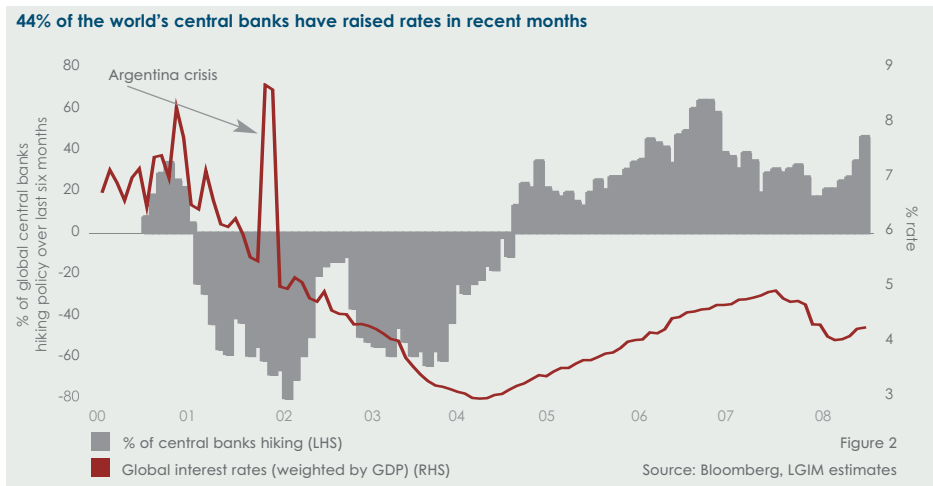
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Market Overview

Snapshot: US housing market

Forecast: Rates to fall in 2009

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trend lasting. Instead, we believe that the severity of the current economic downturn is likely to contain medium-term inflation pressures, particularly in the developed world. That would allow global monetary policy to ease over the next year.

Together, lower inflation and looser monetary policy should boost equity markets. But since the reason central banks will be cutting interest rates is to respond to weaker economic activity, profits may continue to suffer as growth slows. With banks still reluctant to lend, it's unclear when economic growth will stabilise. But it's possible that the US housing market will bottom out over the next year. This would reduce uncertainty in the banking sector and could sow the seeds of a sustained economic and stock market recovery from the second half of 2009.

Inflation and Monetary Policy

Financial markets rallied last summer as the Federal Reserve cut interest rates to deal with the credit crunch. At the time, we warned the rally was premature because global inflation pressures remained. Although the Fed continued to cut interest rates, other central banks carried on raising them. The most noticeable example is the ECB, which increased rates by 0.25% in July.

The ECB was not alone. Many emerging economy central banks have also tightened policy, including all of the BRICs (Brazil, Russia, India and China). In fact, 44% of global central banks have hiked interest rates over the past six months in an

attempt to slow growth and combat inflation. This helps explain why stock markets have remained under pressure.

Economic growth

The good news is that this global policy tightening might be over. The bad news is that this is because a sharp economic downturn is underway. Our measure of global capacity utilisation has started to fall rapidly (Figure 3). It currently remains above normal, suggesting inflation pressures remain. But if our forecasts are right, utilisation rates should fall below average as we head into 2009, particularly for developed world labour markets. This should allow policymakers to become more relaxed about inflation over the medium term.

In particular, we do not expect a 1970's-style wage-price spiral. Our 'strike' index suggests UK and euro-area workers are currently more worried about their jobs

than inflation (Figure 4). This is in contrast to what we saw in 2006/07 when German workers in particular successfully won large pay rises after going on strike.

While the lagged effects of tight labour markets and rising import prices will underpin underlying inflation during 2009, we expect UK and euro area inflation to fall below target during 2010.

Recession alert

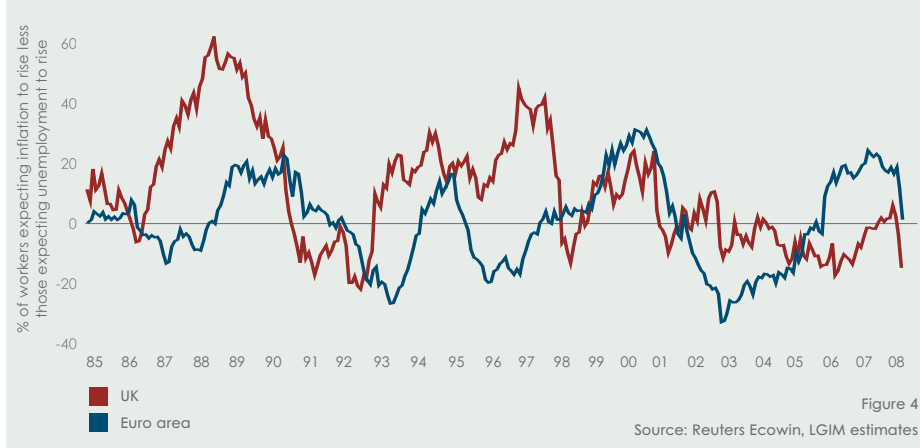
This stems from our view, published in May, that the UK economy was likely to enter recession. The Bank of England now shares that view. In its August Quarterly Inflation Report it acknowledged that the UK economy was unlikely to grow in coming quarters and this would push inflation below target over the medium term. This should pave the way for further rate cuts as we head into 2009. The ECB is also likely to eventually cut interest rates as the economy remains weak and headline inflation rolls over. We currently expect both the Bank of England and the ECB to cut interest rates aggressively in 2009. Our models suggest the Bank of England base rate could fall below 3%.

The outlook for commodity prices and developing country export prices remains more uncertain. The oil price doubled between July 2007 and July 2008 but it has fallen back in recent months. Even if we assume import prices of manufactured goods continue to rise, we still believe UK inflation will hold below target from 2010 as a result of rising unemployment.



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Our 'strike' index suggest workers are more worried about their jobs than inflation



If we're right that developed-world inflation will remain contained during the medium term and global central banks loosen policy in 2009, there is scope for the equity market to re-rate. In Figure 5 we have plotted the earnings yield of the US stock market (using a 10-year moving average of earnings to smooth out the economic cycle). At 4.1%, this is currently the highest yield since the beginning of the last stock market rally in 2003.

Cheap valuations

We have taken a 'fair value' estimate of this earnings yield based on the volatility and level of inflation. The difference between the two series tells us if equities are expensive or cheap. At present, equities appear slightly cheap. Only if we see a sustained, permanent increase in inflation would current ratings be justified.

The combination of lower inflation, looser monetary policy and cheap valuations sounds supportive for equity markets over the next year. But any rally might prove short lived. That's because the reason inflation is coming down and central banks are cutting rates is because of the severe economic downturn. It's likely that profits estimates will continue to be revised down. In which case the equity risk premium is likely to remain high.

Forward looking

Traditionally, the equity market has rallied two quarters before the economic cycle ends. However, the early 1990s was a clear exception. In that instance, the equity

market bottomed five quarters before the economy did. But this probably reflected an elevated risk premium resulting from Iraq's invasion of Kuwait. In 1990, the oil price jumped from \$17 in June to \$40 by end September before falling back to \$25 by year end.

One reason equity markets bottom just before economic growth returns to trend is that profits are driven more by changes in economic growth than the actual level of growth. The reason for this is that unexpected swings in demand can catch firms off guard, affecting profits. For example, during an upswing firms are busy hiring. If demand suddenly slows, their costs are rising, but their revenues slow, so profits fall. Conversely, when the economy is weak and firms are cutting costs, an unexpected rise in demand will boost profits. We therefore don't necessarily need to see GDP growth return to trend to boost profits, it just needs to improve.

Lead indicators

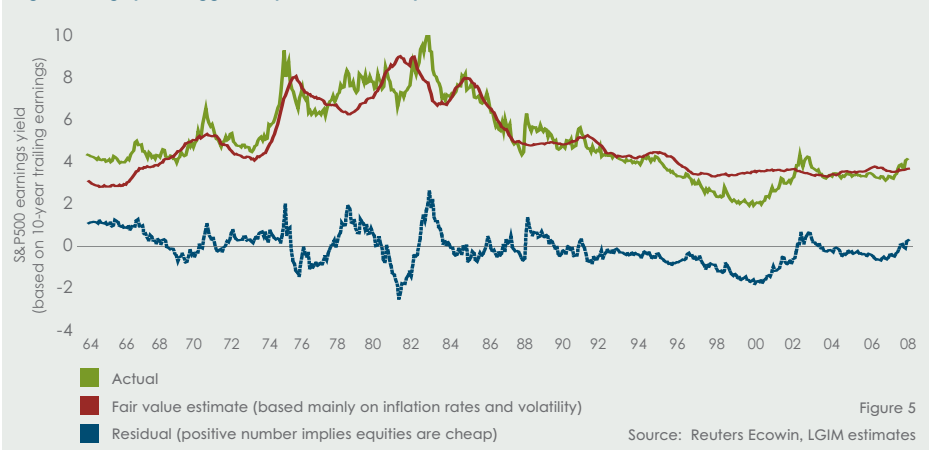
We have developed a series of lead indicators for the major economies that aim to predict economic growth up to a year in advance. Unfortunately they're currently pointing to worsening economic data ahead (Figure 6). This is because credit conditions continue to tighten. In the US, banks are tightening lending standards at the fastest rate since 1974 (Figure 7). This points to further weakness in car sales ahead, even if oil prices continue to drift lower. It suggests corporate construction spending – which is still rising at a double-digit rate – should collapse. It suggests new businesses will struggle to raise capital, depressing equipment and software investment. It also suggests house sales will remain depressed.

Home sales

The one bright spot is that although home sales are unlikely to recover over the next year, it's unclear whether they will fall further. As a percentage of households, new home sales are at lows reached in previous economic downturns. So it's possible that home sales trough at these levels. Indeed, new home sales have broadly moved sideways since March.

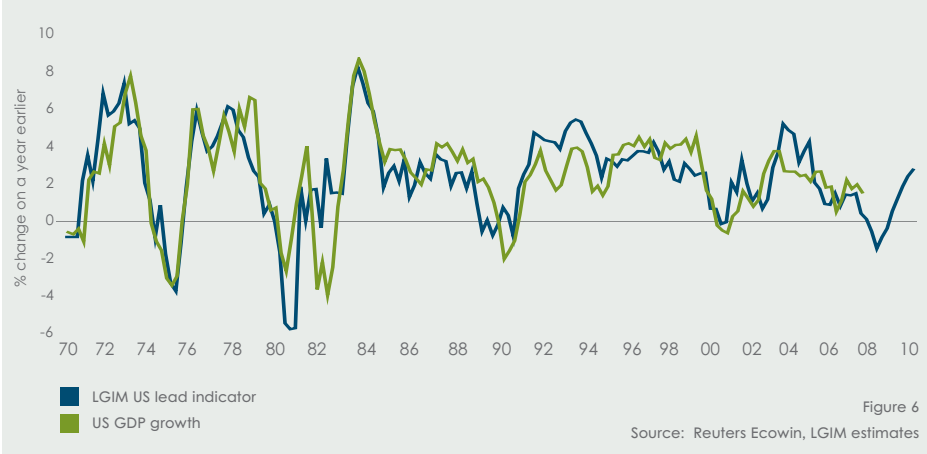
Stronger home sales data is good news for two reasons. First, because housing starts are also at lows reached in previous downturns. If new home sales don't fall further, housing starts don't need to fall further either, so the drag on economic growth from weaker housing construction activity should fade.

High earnings yield suggests equities reasonably valued



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Our lead indicators point to further economic weakness



More importantly, inventories of unsold homes should continue to fall, potentially stabilising house prices. In absolute terms, inventories of unsold homes have already fallen by more than 20% during the past year. But the so called ‘month’s supply of new homes’ ratio (unsold inventories relative to new home sales) has not yet fallen because sales have fallen just as fast. If sales flatten off, then this measure of inventory overhang should fade.

This is significant because historically there has been a close relationship between inventories of unsold homes as a percentage of home sales and house prices. Our analysis suggests a stabilisation of new home sales could lead to house prices flattening off by 2010 (see Snapshot page 7).

The banking sector

It is possible that a stabilisation of house prices will improve confidence in the banking sector. After all, much of the current financial crisis stems from leveraged losses on mortgage debt. It is possible to model both bank write offs and lending standards using a combination of house prices, lagged debt, changes in unemployment and interest rates. If house prices begin to stabilise while unemployment increased, our models would expect a gradual improvement in bank lending conditions. We don’t expect a return to easy conditions – merely that conditions become less tight. This should result in a gradual improvement in economic activity by the end of 2009.

While we don’t expect US GDP growth to be above trend until 2010, we explained how, historically, profits have benefited from a change in the rate of growth, rather than the level. So a modest improvement in GDP growth in the second half of 2009 is consistent with an improvement in profits. If we combine this with falls in inflation, looser monetary policy and attractive valuations it points to a rally in equity markets during the second half of 2009.

What’s next?

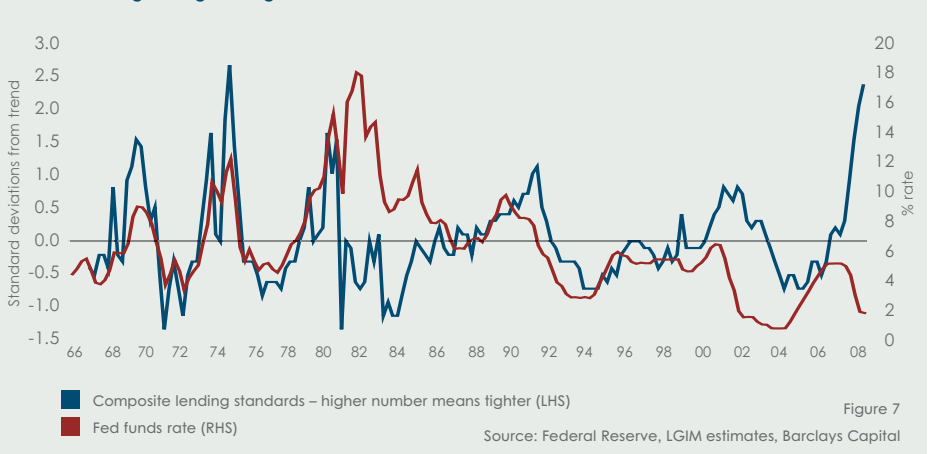
We have outlined the factors we believe are necessary to generate a sustained recovery in equity markets – low inflation, looser monetary policy, cheap valuations and an improvement in economic growth. The timing of the recovery in markets will therefore depend on the timing of these factors.

If central banks around the globe are more forward-looking than we expect and slash interest rates sooner rather than later, it would likely bring forward a recovery in equity markets. Similarly, if commodity prices continue to fall, it would depress inflation and boost economic growth.

On the downside, we could see further bank losses as global unemployment rises. If banks remain unwilling to lend, we can’t rule out a more prolonged economic downturn, perhaps as severe as the 1930s. Looser fiscal policy could help by boosting growth and/or tackling banks bad debt. It’s worth re-emphasising that we have to see further economic weakness in the near term. Our measure of global capacity utilisation is currently above trend. If the global economy were to immediately recover, inflation pressures could remain and global policy rates could tighten.

To summarise, we remain cautious about the near term outlook for equity markets. We believe that in order to ensure inflation remains contained, we need to see further economic weakness and further downward revisions to profit estimates. If this is followed by aggressive policy easing and an improvement in bank lending conditions, then a more sustainable equity market rally could begin in the second half of 2009.

US banks are tightening lending standards at the fastest rate since 1974



Market Overview

Developed economies continue to struggle. Last month the Bank of England’s Monetary Policy Committee flagged that economic growth in the UK would ‘slow sharply in the near term’ – predicting flat output over the next year. The US economy remains shaky in the wake of the financial crisis, and in Europe even the economies which had been holding up better (such as Germany) have recently taken a dive. Higher food and energy costs, housing market declines and tighter lending conditions in the banking sector have combined to produce a significantly painful period of adjustment for most of the major economies. While this has made for a difficult operating environment for financial markets, it has also created potential investment opportunities.

Nobody enjoys seeing their investments decline in value. However, broad-based periods of market decline serve to ‘burn-off’ speculative bubbles and ensure that assets are brought back to their ‘fair value’. A slow-down in global economic growth has been necessary to ensure inflationary pressures are maintained. Also, the credit crisis has sparked a global re-evaluation of risk forcing the world’s largest banks to reassess the level and types of debts they take on. This has made them take actions which will likely strengthen the global financial system over the longer term.

Equity Overview

▶ UK Volatility continues

The UK economic environment remains challenging. Banking, credit and housing market conditions are deteriorating and the BOE expect inflation to rise as high as 5% in the coming months.

Against this backdrop, UK equities (as measured by the FTSE ALL Share index) were one of the worst performing equity markets globally in the month of July (down -3.6%).

In August, the market rose 4.3% and at the start of September performance has dipped slightly. The message is clear – volatility has set in.

Oil and Mining stocks make up a large part of the UK equity market. While these stocks have enjoyed strong market gains over the past year as the oil price doubled and China’s rapid growth pushed up the price of raw materials, recent falls in energy and commodity prices caused these sectors to decline.

▶ US The Government goes shopping

Current data suggest it’s harder to obtain a bank loan in the US now than 1974. This is significant as bank credit availability is a key driver of economic activity. Since the credit crisis began, the US government has been actively trying to stimulate growth, stabilise the housing market and underpin the financial system. In September, the latest attempt came in the form of nationalising the two largest mortgage agencies – Freddie Mac and Fannie Mae.

After falling 1% during July (S&P 500 index) US equities rose 1.2% in August. However at the start of September, despite the government’s efforts, further banking sector concerns rattled the financial sector and a fall in the oil price weighed on energy firm’s stock prices.

The US housing market continues to be crucial for US equities. Once US house prices stabilise, banks will find more comfort in lending and the drag on the economy from a lack of construction and housing investment should begin to fade.

▶ EUROPE Strong Euro bites

A slowing global economy coupled with an appreciating Euro has been weighing on Europe’s exporters. In the past year the Euro has appreciated around 20% against the Pound Sterling.

In recent months, even the European economies that have been holding up better (eg. Germany) have deteriorated as tighter credit conditions and falling real incomes (associated with higher inflation) continue to squeeze consumer spending. While there has already been considerable cost cutting undertaken in the US, many European companies have yet to undertake any meaningful adjustment.

The major European markets remain volatile. In July the German DAX Index rose 1% while the French CAC 40 Index declined 1%. In August the DAX fell back almost 1% while the CAC was up 2.1%.

Major Equity Markets – Total Returns £ 2007/2008

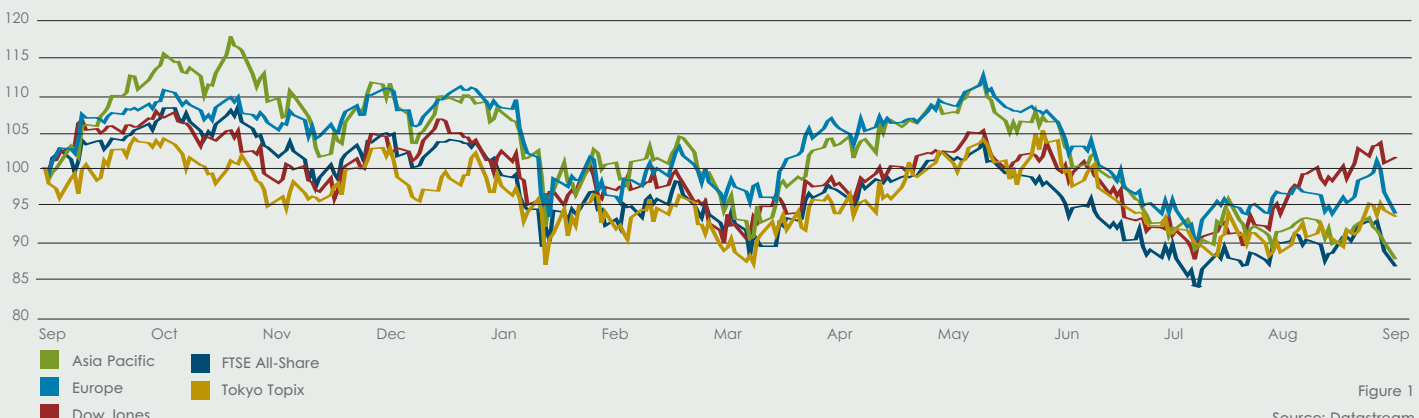


Figure 1
Source: Datastream

Equity Overview Contd.

JAPAN

Fickle foreigners

At present, equity market valuations are trading around 34 year lows and more than half of the market is trading below book value. Interestingly, as a whole, the yield on the stock market exceeds what the Japanese bond market is offering.

Back in April, we saw the largest inflow of foreign investment into Japan since the 1970's. In the past two months, however, there has been little interest in Japanese equities from offshore. As foreign money has been withdrawn, the equity market as a whole has struggled. Indeed, outflows have even served to drive down stock prices in high quality companies with strong earnings, high market share and proven management teams.

As measured by the Topix Index, the Japanese sharemarket has trended lower during the past three months.

ASIA / EMERGING MARKETS

A mixed bag

Amidst significant volatility, the performance from major Asian and Emerging stock markets has recently been a mixed bag. In August the best regional performances came from the Philippines (+10.9%), Thailand (+9.4%) and India (+6.9%). The Chinese market was broadly flat (+0.5%) and there were some significant market declines in Brazil (-6.4%), Korea (-7%) and Russia (-16.3%).

Since the Philippines and India rely heavily on oil, their markets have strengthened as the oil price has declined from the mid July high of US \$147 per barrel to levels at around \$115. In India, however, the government downgraded its economic growth forecast for the current fiscal year to 8% as inflation remains elevated (last month wholesale price inflation rose to a 16 year high of 12.4% year-on-year).

The Russian stock market has sold-off considerably in recent months amidst the war in Georgia and the decline in the oil price (Russia is rich in oil reserves).

Brazil, a major supplier of raw materials such as iron ore and steel, has also experienced stock market declines due to the recent fall in commodity prices.

In China consumer price inflation slowed to 6.3% (year-on-year) in July, export growth remained strong (at 27% year-on-year) and the banking sector reported strong profit growth. The China Merchants Bank reported a 116% rise in profits as it improved loan margins and maintained fees from credit cards.

Across the yellow sea, the Korean stock market was one of the worst performing markets in Asia as headline inflation rose and the Korean central bank raised official interest rates by 0.25% to 5.25%.

Fixed Income Overview

The credit crisis has led to large scale write downs from leading banks in the US, Europe and the UK, and has created a climate of risk aversion. As a result there has been some significant falls in global government bond yields – lower yields translate into higher prices which mean stronger returns for bond fund investors.

The market for corporate bonds, however, has been challenging. The availability of credit to both companies and consumers remains restricted and bank balance sheets remain weak, inter-bank interest rates (London interbank offered rate or LIBOR) – a key barometer of the health of credit and money markets – remains stuck at historically high levels raising concerns that the worst of the credit squeeze may not be over as yet.

To help stabilise financial markets, the Fed has aggressively taken a number of measures to underpin the financial system. The latest being the nationalisation of Freddie Mac and Fannie Mae.

Major Bond Markets – Total Returns £ 2007/2008

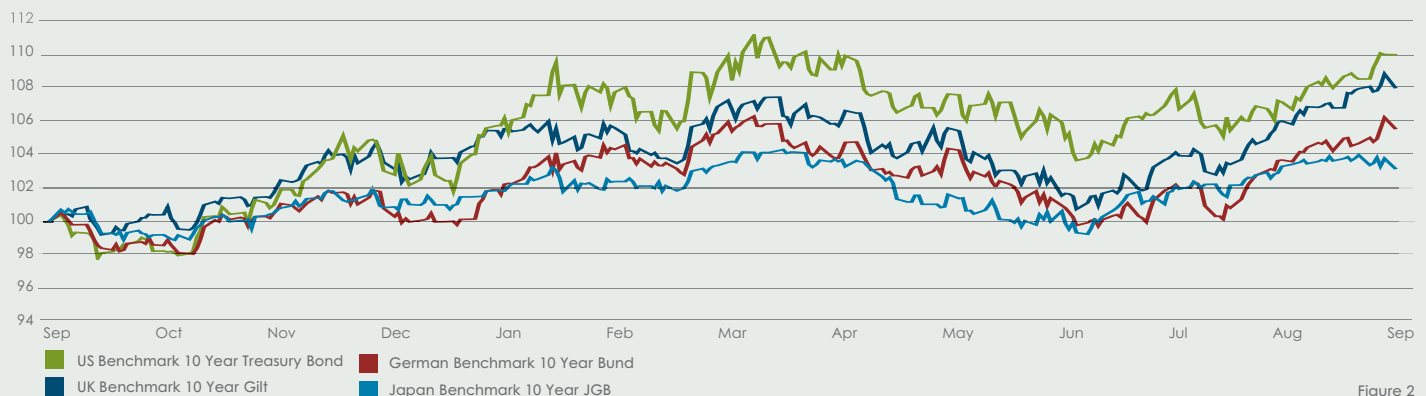


Figure 2
Source: LGIM

Snapshot

US housing market

There is little prospect of a significant improvement in global credit market conditions before the scale of financial losses are known. This requires US house prices to stop falling. The good news is the US housing market adjustment is well advanced. Prices have fallen sufficiently to make houses no longer overvalued. Housing starts (a signal of new construction activity) have collapsed around 60% from their peak and residential investment as a share of GDP is close to a record low. This means the direct drag on the economy from declining home building is about to fade. But housing sentiment remains extremely depressed with the National Association of Homebuilders' survey remaining at record lows. Home sales have continued to fall and rising foreclosures have added to the bloated stock of inventories. But there are tentative signs that home sales have stabilised in recent months. They have reached levels previously only experienced at the worst points of the early 1980s and 1990s recessions (Figure 1) and, in spite of the credit crunch, mortgage rates are currently considerably lower.

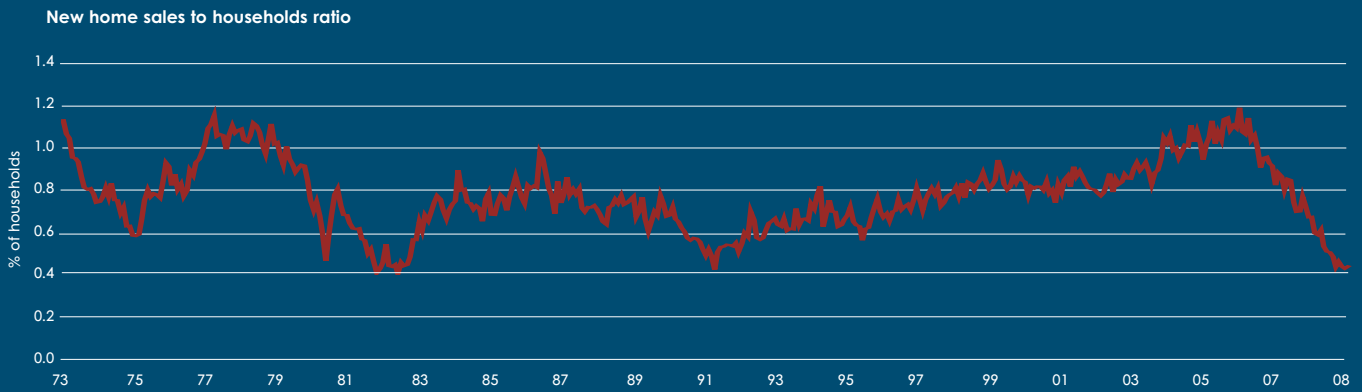


Figure 1
Source: Reuters Ecowin, LGIM estimates

Total housing inventories are already falling, but because sales have fallen even faster, the ratio (months supply of inventories) has continued to climb. If sales stabilize this should help to clear excess housing inventories. House prices tend to respond to the months supply of inventories with a lag of around two quarters. This implies the rate of house price declines should now begin to ease. We would expect house prices to stop falling towards the end of 2009 (Figure 2).

While a stabilisation in US house prices should mark the end of the financial crisis, the recovery in the overall economy is likely to remain weak. This is because the household sector has only just begun to respond to the lower levels of net wealth. As households slowly rebuild saving to make up for lost housing wealth, consumer spending growth is likely to remain relatively subdued.

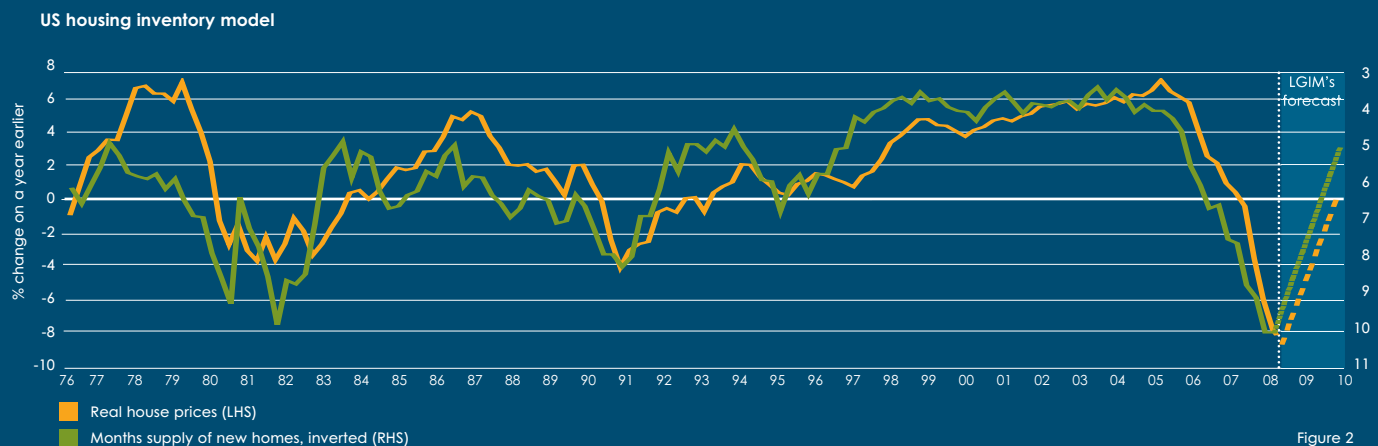


Figure 2
Source: Reuters Ecowin, LGIM estimates

Forecast

Rates to fall in 2009

		Price Inflation (HICP)		GDP (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro	
		Average 2008	Average 2009	Average 2008	Average 2009	End 2008	End 2009	End 2008	End 2009	End 2008	End 2009	End 2008	End 2009
		%	%	%	%	%	%	%	%	%	%	%	%
Market participants forecasts	High	4.20	3.50	1.80	2.00	5.00	5.15	5.00	5.00	1.95	1.94	0.86	0.83
	Low	3.20	1.80	0.80	-1.60	4.20	4.00	4.50	3.00	1.68	1.58	0.78	0.72
	Median	3.70	2.60	1.40	0.90	4.56	4.66	4.75	4.00	1.80	1.75	0.81	0.77
	Last month median	3.80	2.80	1.30	0.80	4.75	4.77	4.75	4.00	1.90	1.82	0.79	0.76
Legal & General Investment Management		3.90	3.30	1.00	0.00	4.00	4.00	4.75	2.75	1.75	1.75	0.80	0.80

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.

Our forecasts remain more cautious than consensus. Falling housing prices, tighter lending conditions and higher unemployment lead us to anticipate no growth for the 2009. While we have been cautious for some time (flagging the possibility of a recession in May) the median consensus forecast has been aggressively revised down during the past few months.

Despite the Governor of the Bank of England (BOE) projecting broadly flat output over the next year in the Bank's August inflation report, consensus estimates for 2008 and 2009 are 1.4% and 0.9% respectively.

Last month we revised our inflation forecasts higher. While consensus anticipates inflation at 3.7% during 2008, falling to 2.6% on average in 2009, we believe inflation will average 3.3% in 2009 – remaining sticky due to the lagged effects of a weaker pound.

Our Bank of England model is currently indicating that the next move in official interest rates is down. We see the possibility of a 0.25% rate cut as early as the end of 2008, with more aggressive policy easing in 2009 as inflation falls back and growth remains weak. Our forecasts indicate that UK official interest rates will decline to 2.75% by the end of 2009.

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