

Strategy Matters

Issue 2008 – 1

The Year Ahead

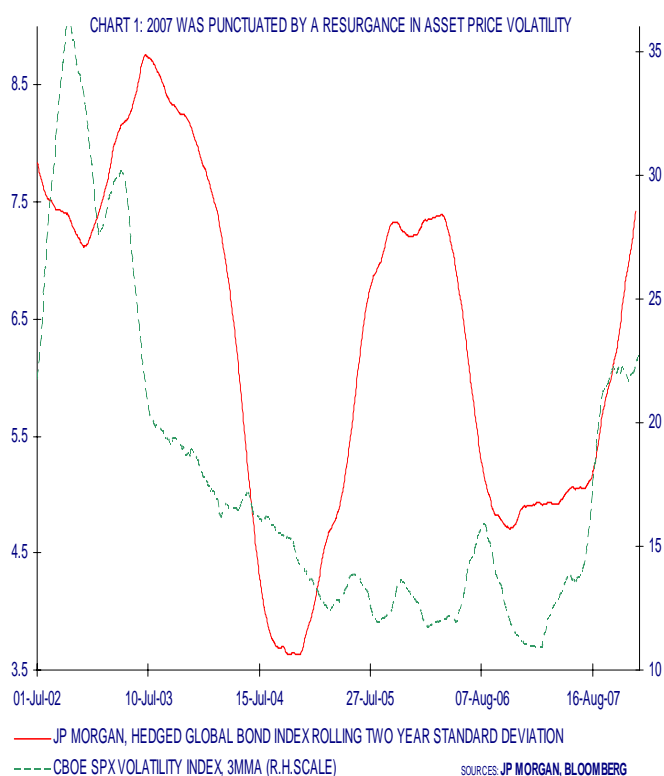
Risks to the global economy are significantly higher than this time last year. As the US housing recession deepens and the prices of oil and food rise, the risks to the U.S. consumer are not trivial. Concerns regarding financial companies' holdings of opaque securities related to mortgage and other debt obligations continue to swirl in the background. But with concerted central bank action and on the back of solid growth in emerging markets we believe the global economy should be able to side-step recession.

2007

The first half of 2007 unfolded much like the previous three years in the most recent bull market. The equity rally continued unperturbed, apart from a couple of harmless corrections. Credit spreads hit new lows seemingly on a daily basis. 'Highly rated' structured credit remained well bid as investors hunted for yield. And government bonds continued to provide no value. Volatility was low. Everyone was making money.

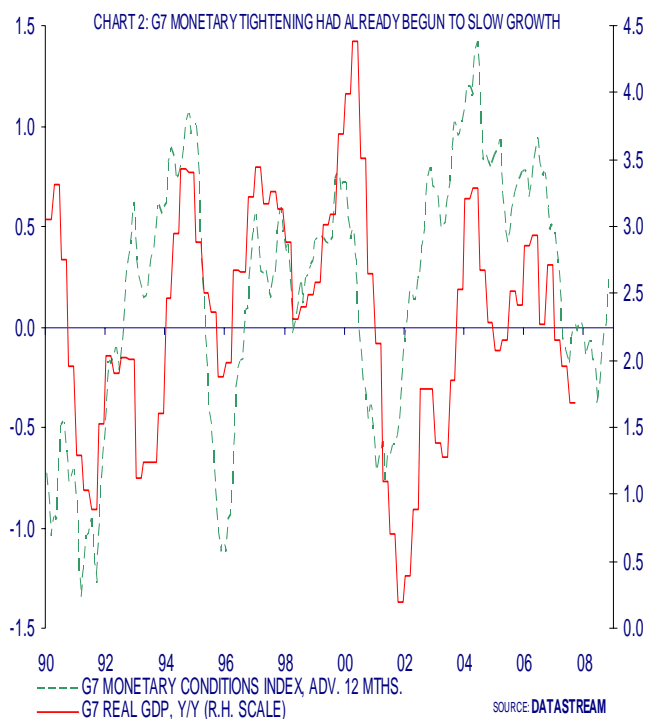
But when news surfaced in mid-June that two of Bear Sterns' structured credit funds had become impaired forcing the bank to prop them up, followed by similar news from a Goldman Sachs fund and an assortment of others, financial markets began to wobble. And so the second half of the year went from one piece of bad news to another. Eventually global money markets began to seize up as banks and other financial companies, shaken by the increased volatility and potential for their debtors to incur significant losses, curbed their short term lending programs. Asset price volatility spiked (Chart 1). Equity markets whipsawed around.

Credit spreads blew out. The structured credit market effectively shut down as issuance



ceased altogether. And investors piled into the safest assets they could find: cash and short-dated government securities. At the same time as global money markets became impaired, it became increasingly apparent that G7 growth was decelerating under the weight of previous monetary tightening (Chart 2). Leading indicators such as the ISM series in the U.S., the IFO in Europe and the Tankan in Japan showed that corporate expectations had begun to deteriorate at the same time as companies' sentiment on inventory signalled that it was too high. The corporate sector was becoming increasingly cautious on the demand outlook. And whilst consumption remained reasonably strong, the weight of falling house prices in the

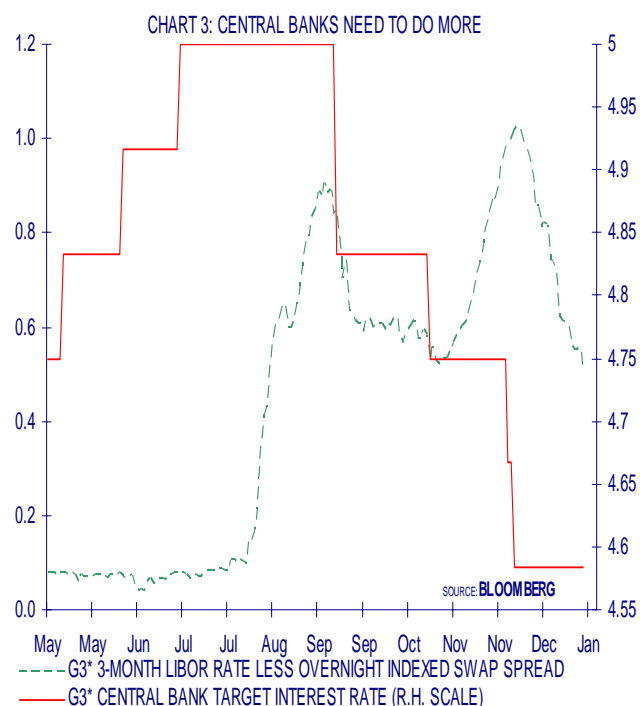
U.S., sluggish real income growth in Europe and Japan and generally negative newsflow had begun to weigh on consumer expectations (Chart 9).



Initial reaction by global central banks was varied. The U.S. Federal Reserve (FED), which had already seen more obvious signs of a slowing in its economy, injected liquidity on a number of occasions and eventually began to cut its target interest rate. The European Central Bank (ECB) also injected liquidity but, with little sign of a slowdown and a budding inflation problem in the Eurozone economy, abstained from cutting its main rate. Initially, the Bank of England (BOE) injected less liquidity than its counterparts and took a hard line with banks and other market participants which had engaged in what it called 'excessive risk taking'. The BOE later endured significant criticism for its handling of the banking crisis which led to a run on the fourth largest British lender. Eventually, the BOE was forced to cut interest rates as the housing market had begun to slow sharply, consumer spending appeared to be at risk of a slowdown and money markets remained impaired. Other central banks implemented similar measures including an interest rate cut from the Bank of Canada (BOC). However, central banks' various

measures did little to help re-start seized money markets.

As a result, the BOE, ECB, FED, BOC and Swiss National Bank announced a series of joint lending operations on December 12th aimed at re-starting term lending markets. The measures injected liquidity by expanding the amount and type of collateral accepted for lending to financial institutions. The initial auctions were well received. Strains in lending at maturities between three and twelve months, where the credit crunch had been focussed, began to ease. Yet money markets did not fully re-normalize which left investors wondering whether the central bank operations, which had terms of three months or less, would be enough to end the credit crunch.

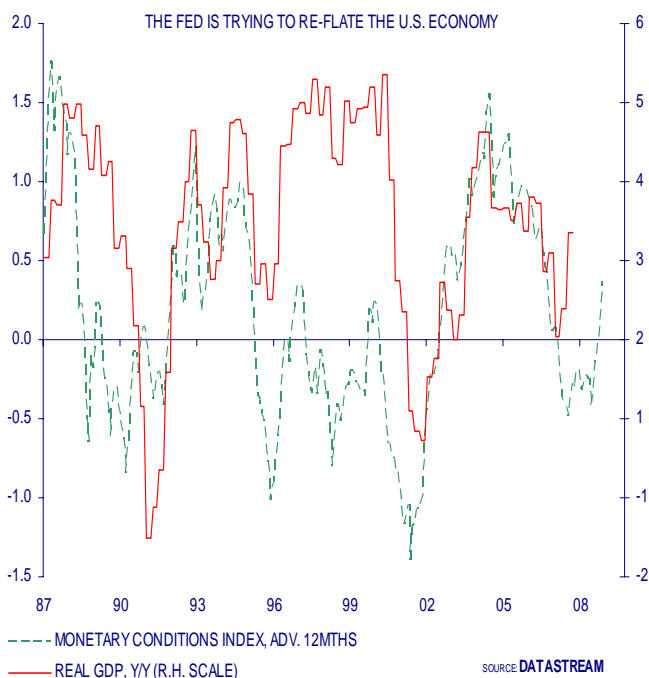


* - G3: UNITED STATES, UNITED KINGDOM, EUROPEAN MONETARY UNION

And this is where the global economy finds itself at the beginning of 2008. Financial market participants continue to ask themselves: whether the credit crunch is indeed over; what impact the additional tightening will have had on the real economy; can central banks continue to cut rates as global headline inflation remains uncomfortably high; will the U.S. go into recession; and, if so, will the rest of the world follow? We provide our thoughts on some of these questions below.

The U.S. housing train wreck

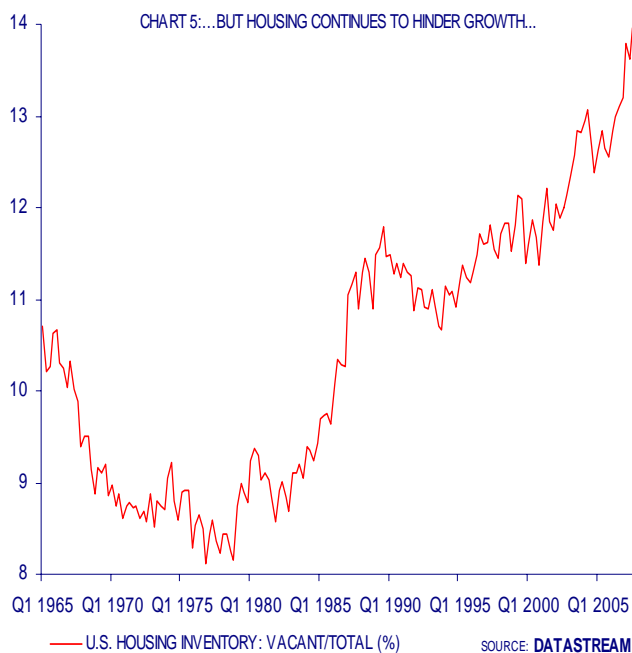
The U.S. is enduring a deflating housing bubble at a time when consumer and corporate expectations are slowly deteriorating. As was the case within most of the G7, monetary policy had already tightened sufficiently in order to slow growth in the U.S. (Chart 4). However, the tightening in policy actually produced an asymmetric shock via the housing market. Since 2003, when the Federal funds target rate fell to 1.0%, banks and other lenders in the U.S. had loosened lending standards and extended mortgages to individuals who, under normal market rates, would not have been able to meet mortgage payments and thus, were not suitable for home ownership. These borrowers were deemed to be sub-prime. Once the Fed re-normalized interest rates and sub prime borrowers began to roll off their initial mortgage



rates (often called teasers as they are at or below the prime rate, which is not sustainable in the long run for a lender to be profitable) into higher ones, many began to encounter difficulties servicing their debt. The result was that borrowers simply handed in their keys and walked away from their obligations. As defaults in the U.S. are non-recourse (lenders have no claim against a defaulted borrower's future income) those who proceeded with these voluntary arrangements were able to move into

rented accommodation and resume their normal spending patterns.

As the number of defaults increased, two major problems arose: first, the houses being vacated added to an already bloated housing stock for sale; and second, the securities which were partially backed by these loans became impaired. The natural consequence of 425 basis points in interest rate hikes was that in late 2005, demand for housing peaked, and prices along with it early the following year. Unfortunately, homebuilders had overestimated underlying housing demand and continued to add to the housing stock thereby exacerbating the price declines. At last measure, the S&P Case Shiller 20 City price index (S&P/CS) showed that house prices had fallen by 6.1% year-on-year (y/y) in October.



Throughout the last five months, U.S. housing and mortgage backed securities have entered a vicious circle. What began as a problem isolated to sub-prime mortgages, and the securities backed by them, has quickly spread to the broader housing market and thus the whole U.S. mortgage backed security market. And house prices could have much further to fall. The reason is that by any measure the inventory imbalance, already at a record high, continues to deteriorate based on the most recent data (Chart 5). During the period between Q1'01 and

Q2'05 prices inflated, and mortgage rates followed, thereby crunching housing affordability. Though affordability has begun to improve since both prices and rates have fallen, there is evidence suggesting that further significant price declines are required to bring supply and demand into balance.

using the Fed's model, but amended for an accelerated path for house price deflation. In it, Mishkin argues that if real house prices were to fall by 20% y/y in the three years following their peak then the reaction function dictates that the Fed funds target rate would be cut by 175 basis points to 3.5%, all else being equal.

Of course, everything else is not equal

The Fed's model of the influence of house prices on the real economy is telling from a monetary policy perspective but it abstracts from a number of key issues including: the potential impact of additional monetary tightening via the credit crunch; the potential negative wealth effect of a fall in equity markets; and the impact of financial market volatility on the financial and business services sectors labour markets (and consumption). Although it is difficult to accurately predict what combined effect housing and the aforementioned factors will have on the overall economy it can be said with certainty that the dynamics will weaken growth further forcing the Fed to continue cutting rates.

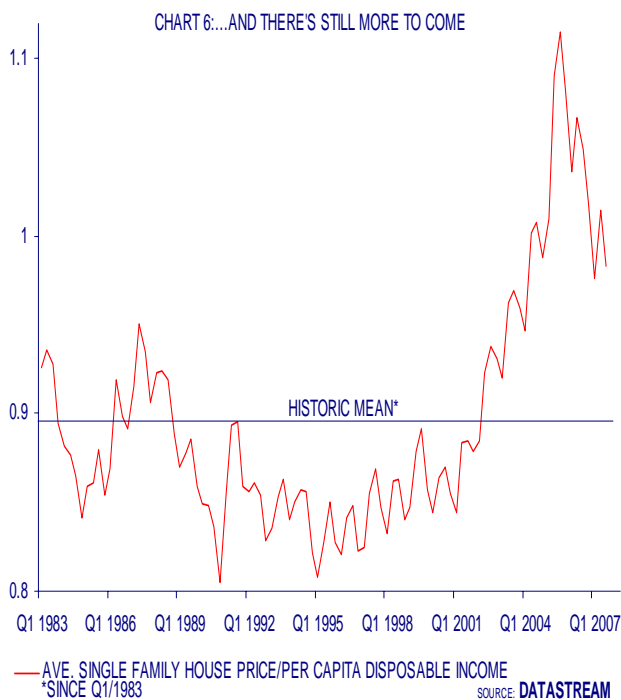
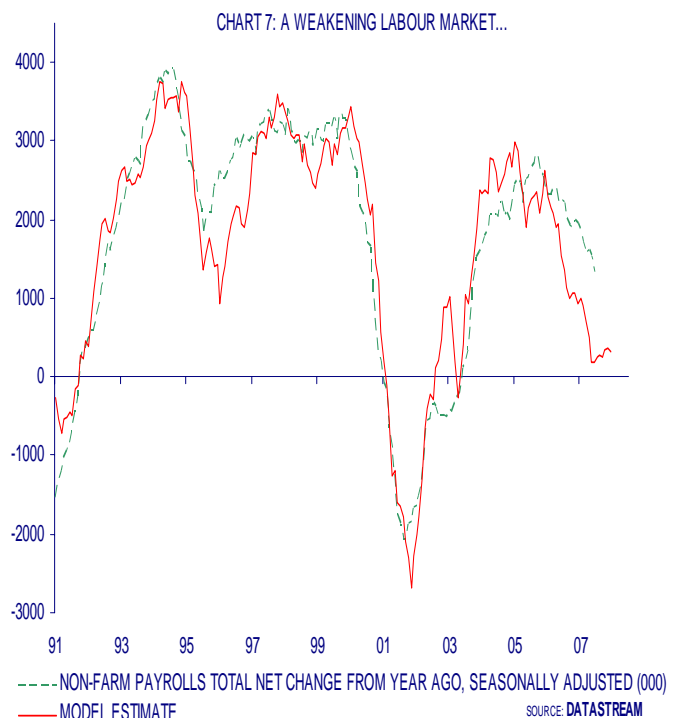


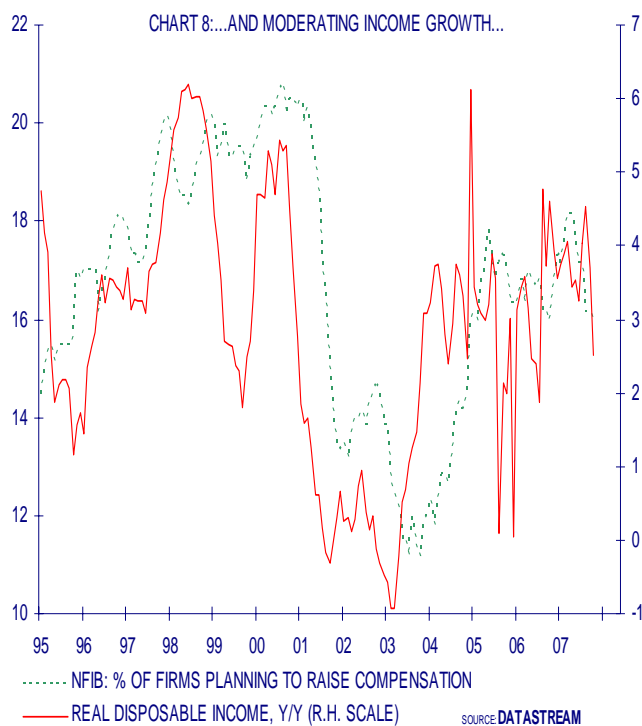
Chart 6 shows the ratio of the average price of existing single family homes sold in the U.S. and per capita disposable income. The relationship suggests that if the ratio were to mean revert, holding income constant, house prices would have to fall another 11% from their current level. An average of the National Association of Realtors and S&P/CS indices suggests that house prices have fallen 3.8% since their peak, in around late 2005 or early 2006 depending on which index you look at, meaning that the cumulative peak to trough fall in house prices could be as much as 15%, or more if the market overshoots.

Such large falls in house prices have not been seen since the housing recession of the early 1980's when real house prices fell by around 16% from peak to trough. The economic impact was not trivial then and the Fed appreciates the impact such a fall could have on the economy. In a working paper released in August, governor Mishkin laid out a roadmap for monetary policy



As Chart 4 (previous page) shows, growth had already been slowing when concerns over the housing market and related securities caused financial markets to wobble. Leading indicators for manufacturing and services had rolled over in June. The labour market was slowly

deteriorating and worryingly, the service sector had begun to shed temporary labour which has traditionally been a precursor to broader labour market problems. Indeed, the model in Chart 7 points to further downside in U.S. job creation, but no contraction as of yet. At the same time as house prices have been falling, equity market returns deteriorating and the labour market weakening, it appears as if another source of U.S. consumption, disposable income growth, has rolled over (Chart 8). All these factors and a 66% y/y (FY'07) increase in the oil price have begun to weigh on the consumer confidence (Chart 9). Though trends in consumption do not always follow those of survey indicators of confidence, the headwinds for US consumers have not been stronger since the last recession in 2001/02.

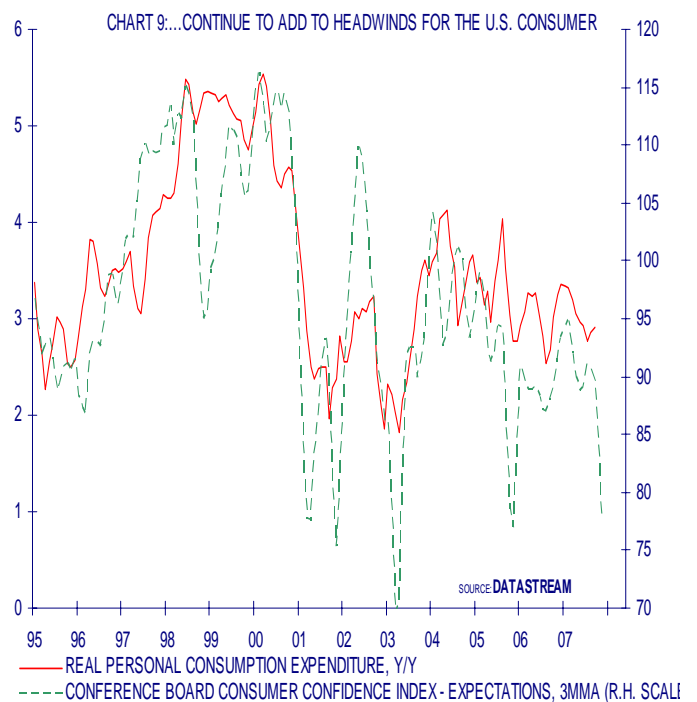


The deflating housing market, mounting consumer woes and still-dysfunctional money markets will compel the Fed to continue cutting interest rates to a least 3.5%, and probably below that.

But will inflation impede the Fed?

The market has become increasingly nervous about the implications for inflation as both headline and core remain elevated at 4.3% and 2.2% (PCE Core) respectively. However inflation should not impede the Fed from cutting rates.

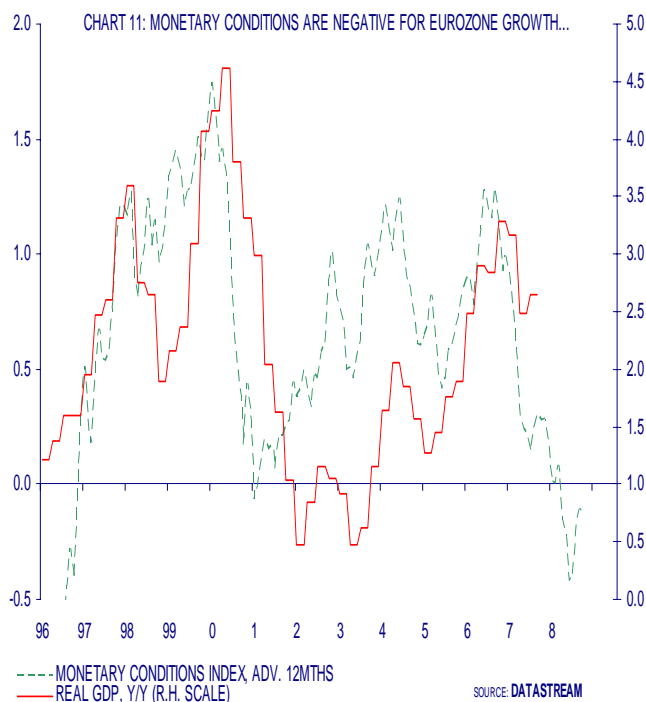
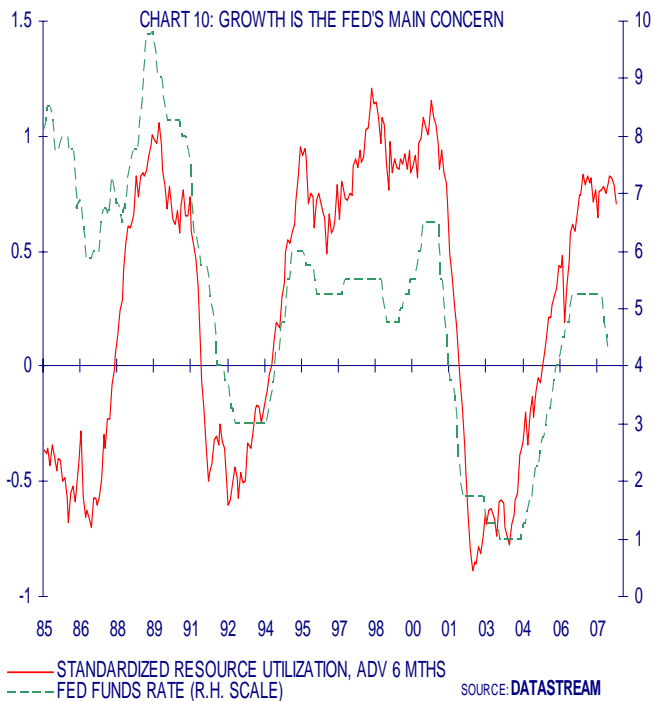
Though it has not stated it explicitly, the Fed is focussed on preserving growth in the medium term. Despite mentioning elevated resource utilization as a concern, the Fed has nonetheless cut interest rates by 100 basis points since September (Chart 10). And given the outlook for further declines in house prices, weakening consumption and a continued easing in resource utilization, headline inflation should ease toward the 2% target in the medium term whilst core inflation will remain subdued. Thus our base case scenario is that the Fed cuts interest rates enough to avoid recession. We see growth averaging around 1% -1.5% in 2008 and the Fed funds reaching a terminal rate of around 3%.



Europe: in between a rock and a hard place

The ECB finds itself in a precarious position in the New Year. Most leading indicators of industrial and consumer activity show that the economy has begun to slow under the strains of tighter monetary policy (Chart 11). However, inflation has surpassed most estimates, including the Bank's, and recently printed 3.1% y/y, over a percentage point above the ECB's target 2% ceiling. Eurozone growth exceeded expectations for the second year in a row in 2007. Real GDP grew at an average of 2.9% y/y (Q1-Q3) and hit as high as 3.2% in Q1 supported by both external and capex-led

domestic demand. Government budget deficits narrowed and unemployment fell to multi-decade lows. However, the Eurozone expansion lacked one component: broad based household spending growth which had the potential to extend the above trend growth into a third year.

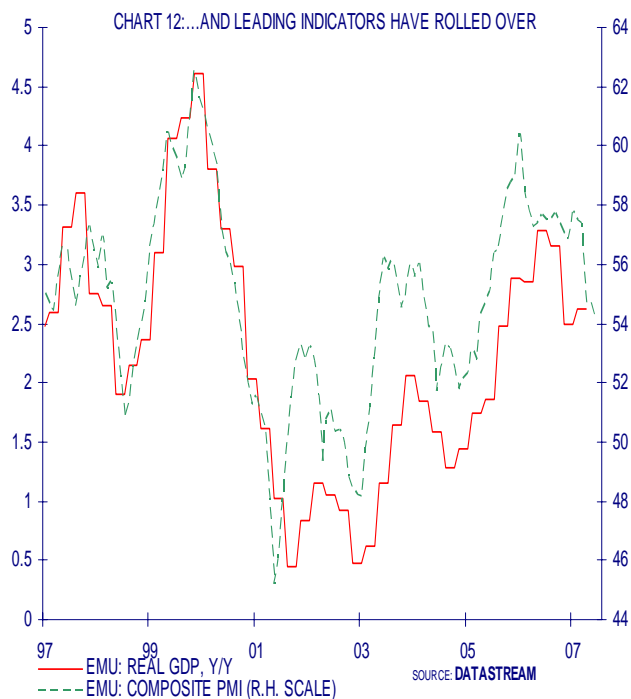


Before we discuss the European consumer, we provide some opinions on the sectors that did

perform well in 2007 and their potential direction in 2008.

Monetary policy has begun to bite in EMU

EMU's corporate sector drove growth in 2008. The external sector benefited from a buoyant global backdrop as export growth hit a cyclical peak of 10% y/y, having averaged around 6% in the 2004-2006 period. The same positive sentiment combined with easy credit fueled solid investment growth as gross fixed capital formation printed 7.5% y/y at its cyclical peak and averaged 4.5% y/y throughout the same period.

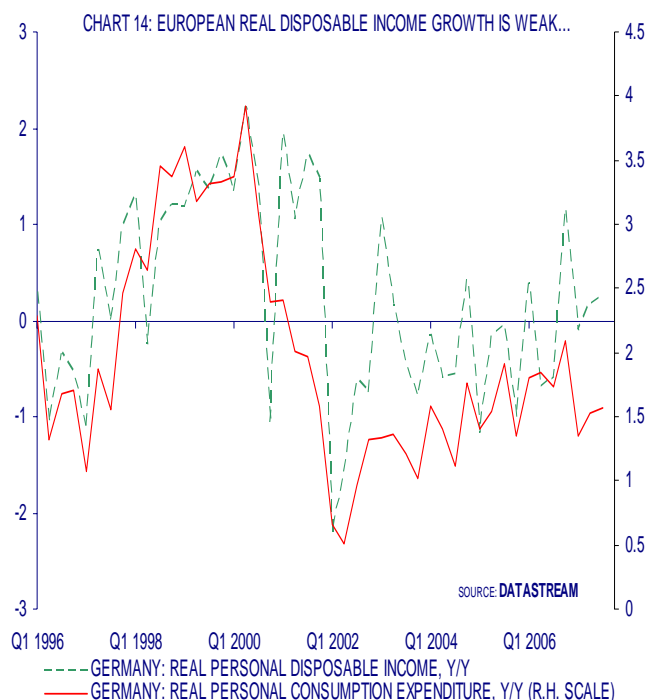
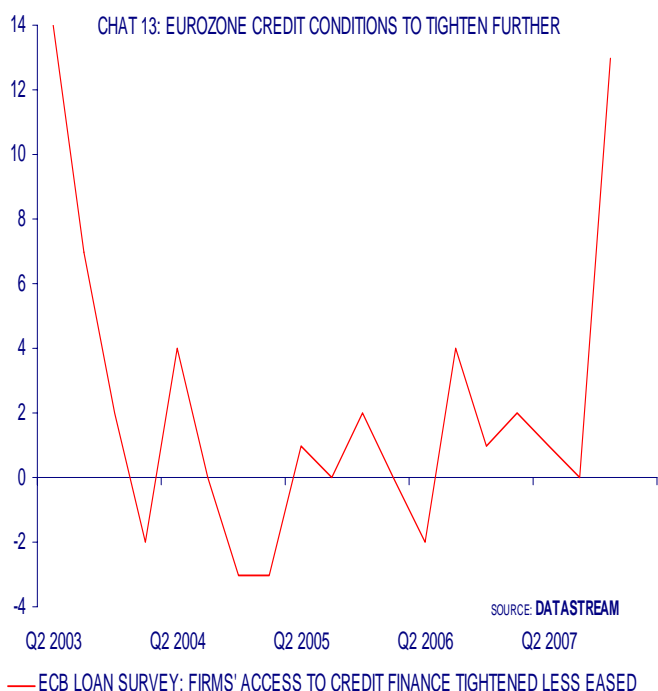


But in recent months, it has become clear that the positive tailwinds have begun to subside. Global leading indicators have rolled over, as has industrial production growth. Perhaps more telling is that export sentiment in global Purchasing Managers' Indices has fallen quite sharply, including the U.S. where the weakening dollar has been a recent boon to America's exporters. The apparent slowing in global demand will become a headwind for the Eurozone, especially given the added strain of a strong Euro.

A good portion of the Eurozone's investment boom has been financed by credit as the cost of

debt has been the cheapest form of financing for a number of years. The tightening in credit conditions and a slowing in final demand has the potential to severely dent investment spending. First, companies will naturally pull back on investment in the face of a slowing demand outlook and in order to improve their financing position which has deteriorated sharply since 2004. The EMU's corporate financing deficit is at its worst level since 1999 at almost 3.5% of GDP. Furthermore, tightening credit conditions (Chart 13) will exacerbate the slowdown as companies needing investment will find it increasingly difficult to finance their plans. The outlook for the two strongest sectors of the Eurozone economy has deteriorated sharply at a time when household consumption continues to flounder.

to struggle to produce significant real wage gains (Chart 14). German real personal disposable income growth came in at a mere 0.2% y/y at the end of the third quarter. And despite an EMU aggregate growth rate of 1.9% in Q2 and sustained job growth, consumer confidence has rolled over (Chart 15). With global demand slowing, credit tightening and companies likely to reign in their investment, it is difficult to expect that the household share of GDP will increase in this environment. The more likely scenario seems to be a trough in the unemployment rate and curtailing of wage gains. Certainly, the confidence and retail sales numbers have borne this out (Chart 15) as the latter has fallen in yearly terms for the first time since April of 2005.



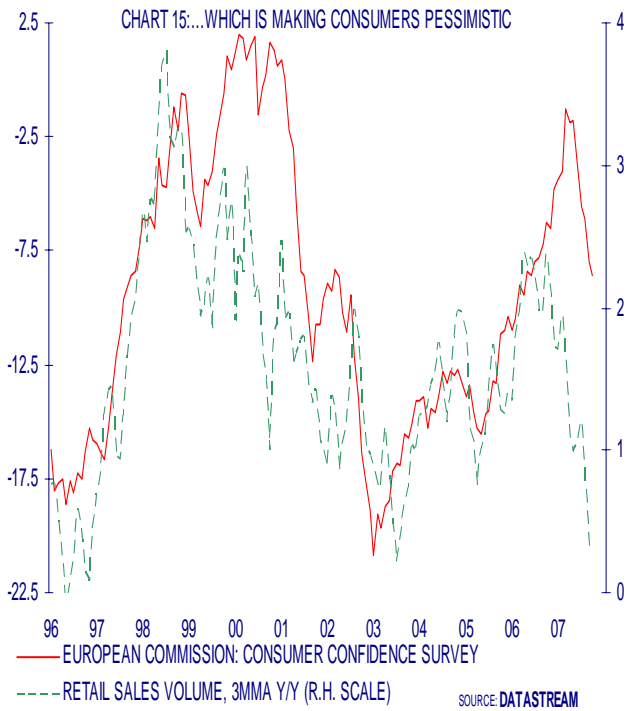
Will European consumers open their wallets?

There was much optimism surrounding the European consumer at the outset of 2007. Unemployment was at multi-year lows and continued to fall, industrial confidence was robust, firms' hiring intentions were rising and consumer confidence was booming. But the consumption boom has not materialized. Q3 Eurozone household consumption was up a paltry 1.7% y/y in real terms and the sluggish growth looks set to continue. The reason for this is that the largest Eurozone members continue

With personal consumption looking like it will remain lacklustre and export and investment growth set to slow, it appears that the Eurozone is set for a significant slowdown in growth in 2008. Under normal circumstances, the market would have discounted a fair amount of interest rate cuts from the ECB with this sort of growth outlook. However, punchy inflation and hawkish rhetoric from the Central Bank has left the expected interest rate profile virtually flat.

It's not so much a question of if, but when...

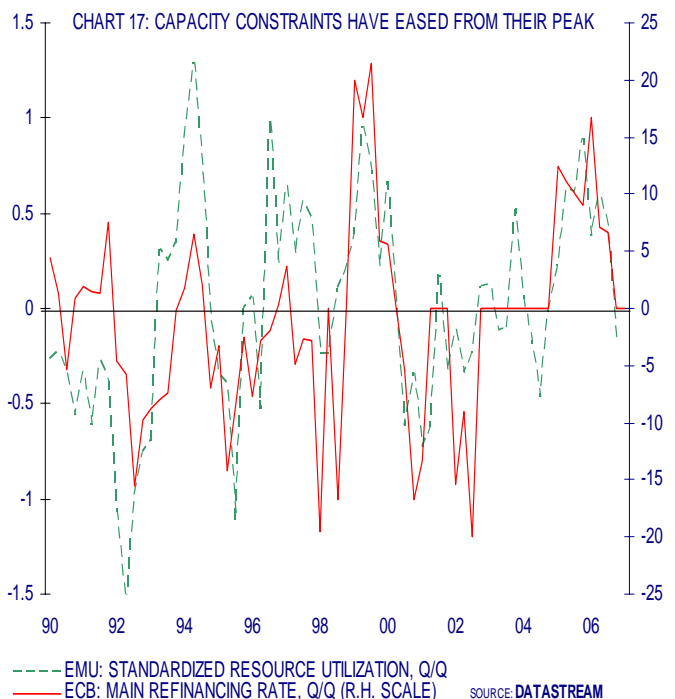
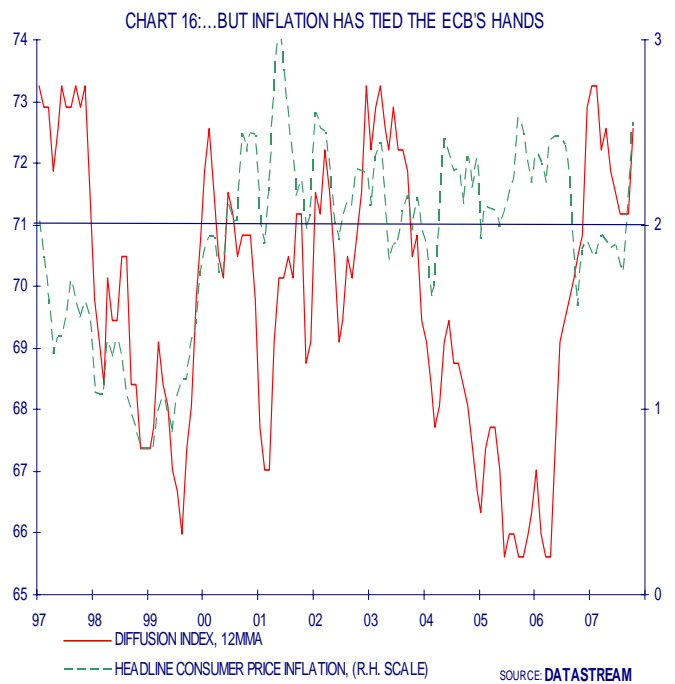
Recent trends in Eurozone inflation have irked the ECB. However, it is doubtful that the committee as a whole has become unsettled by the inflation picture. The ECB's handling of the credit crisis punctuated by a blowout in inflation in the last quarter of the year shows that the



committee remains focussed on its medium term objective of price stability. The hawkish tone employed by committee members has been specifically focussed on anchoring inflation expectations. This is common during peaks in cyclical activity when inflation tends to reach its highest levels in the cycle and it is no different this time around.

The issue with the short term path of inflation is problematic for the ECB because it's rooted in more than just food and energy, as many market participants have argued. A simple measure of the breadth of inflation (Chart 16) in the EMU CPI basket shows that inflationary pressure has become broad based. However, real income growth remains subdued and thus far there have been no major wage deals above 3% though a number of large wage contracts are set to be re-negotiated this year. What gives us comfort is that capacity constraints in EMU have eased in the last two quarters and as the chart shows, this measure is highly explanatory of the ECB's reaction function (Chart 17). Given the outlook

for the Eurozone economy going forward, it is unlikely that the ECB will raise rates again in the near future. As capacity constraints ease and growth continues to downshift, the ECB will become more dovish and eventually cut rates in order to achieve their target in the medium term. This view is predicated upon the major wage rounds not settling much above 3% and inflation not moving significantly higher from its current rate.



The Bank of England got it right...so far

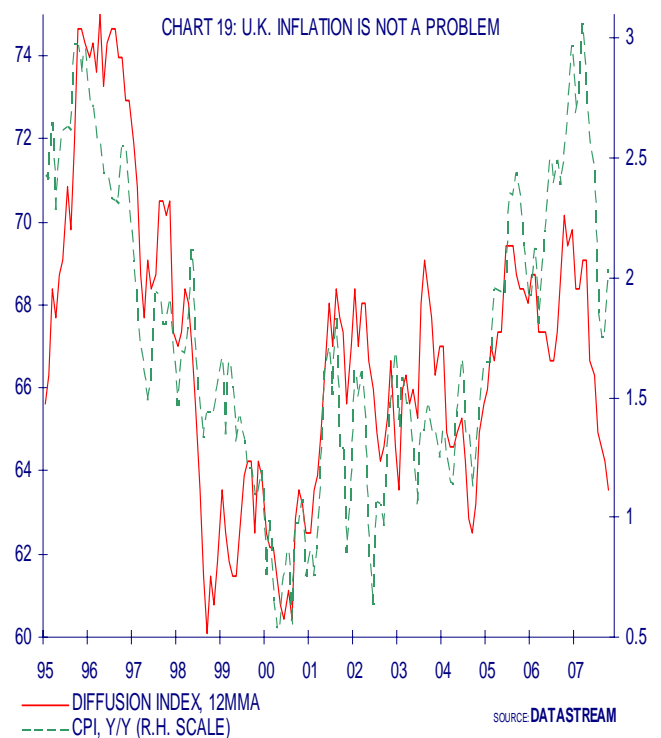
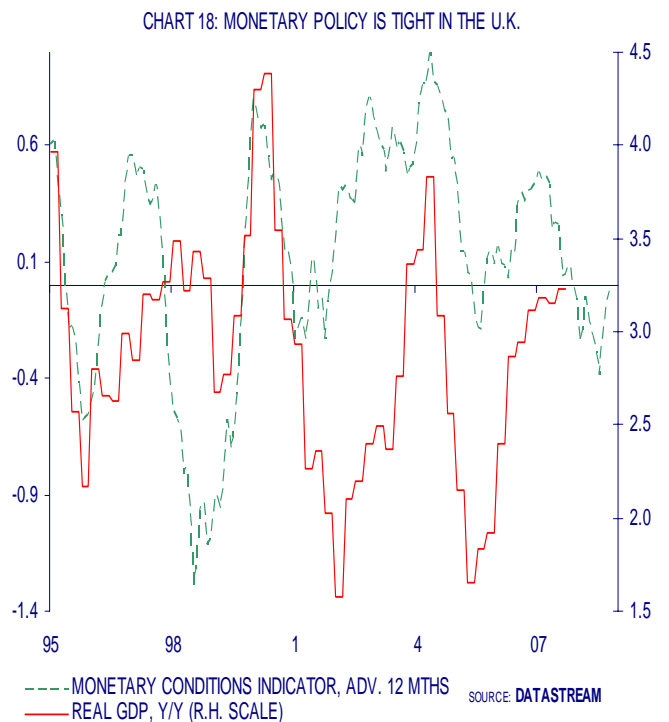
The BOE took a lot of criticism from a number of circles in 2007. First, inflation hawks attacked the Bank for allowing inflation to breach the ceiling of its 2% +/-1% target. Then the Treasury select committee attempted to publicly embarrass members of the Monetary Policy Committee, including Governor King, as to the Bank's handling of the first British casualty of the global credit crisis; the run on the seventh largest U.K. bank Northern Rock. Notwithstanding the criticism, the BOE appears to have called the cycle correctly as it embarks on a monetary easing cycle (we avoid discussing the specifics of Northern Rock as it is strictly a regulatory issue).

U.K. cyclical dynamics are not dissimilar to those of the Eurozone. Monetary policy has tightened (Chart 18) substantially which has caused corporate sentiment to sour. As a result, most forward survey indicators have rolled over. Actual GDP numbers show that growth remained resilient in the second and third quarters of 2007. However, there is one major distinction: the U.K. does not have an inflation problem. The same measure of inflation breadth as shown in the EMU section and applied to the U.K. CPI basket (Chart 19) shows that inflation was not broad based even at its cyclical height. In fact, headline inflation only breached the target on a one off jump in the price of furniture, which was unwound the following month after which it precipitously fell to below the 2% target.

U.K. consumer on the brink

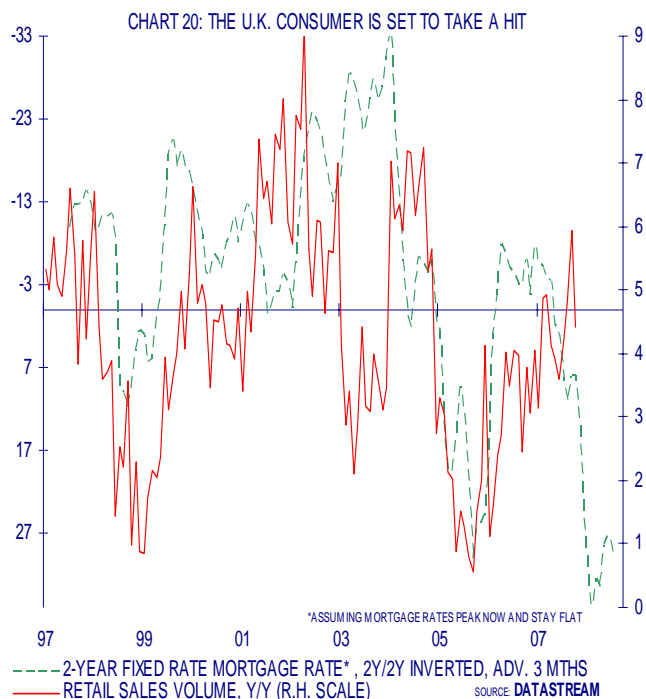
The consumer has always featured more largely in the U.K. than in Europe and this cycle has not been any different. Real household consumption expenditure growth averaged 3.2% y/y during the first three quarters of 2007 and at approximately 60% of overall GDP, has contributed heavily to growth. But prospects for household consumption have deteriorated markedly.

The U.K. consumer is highly leveraged to the interest rate cycle due to relatively high levels of home ownership and a significant balance of floating rate or short fix mortgages. Despite the rise in popularity of fixed rate mortgages, fixing



terms have remained relatively short in the two-three year area. As a result, many homeowners who took out mortgages two to three years ago at attractive rates are now facing resets which will see their interest burdens rise. Chart 20 illustrates the implications of these resets. Based on the two year change on a standard two-year fixed mortgage rate, retail sales

volume growth looks set to decline from growth of 4-5% to 1-2%. Initial signs of weakness in the retail sector materialised in July when the retail deflator turned negative, a sign that retailers were compelled to cut prices to continue to attract shoppers. The deflator proceeded to fall for the following four months and the outlook remains grim according to retailers' initial trading updates for December.



With corporate confidence weakening, the consumer retrenching, the housing sector on the ropes and inflation in check, the Bank of England will continue its rate cutting cycle. We expect at least another 75 basis points of easing and probably more.

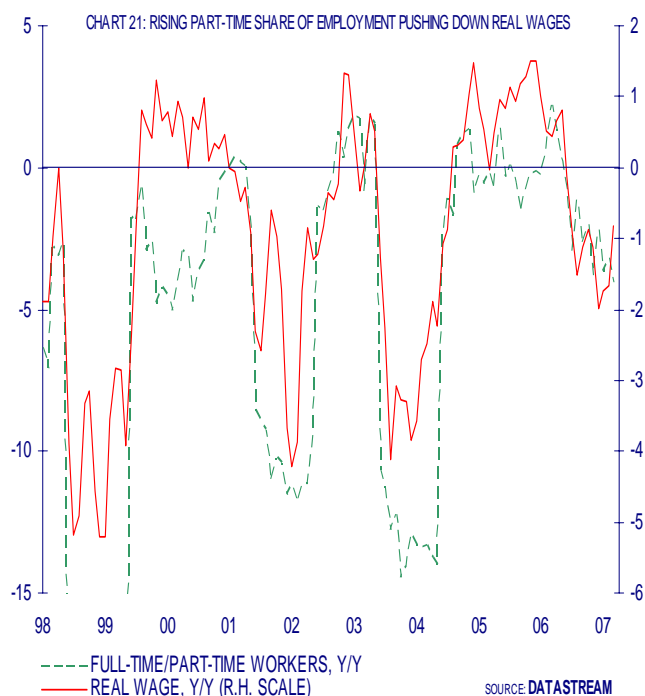
The Bank of Japan will have to bide its time

The Japanese economy continues to recover from the recession/deflation spiral it fell into after the bursting of its housing market bubble in the early nineties, mostly on the back of robust global demand. The Japanese export sector has benefited from robust growth, especially in investment spending in neighbouring Asian economies. Exports rose an average of 7.6% y/y in 2007 which propped growth up at a reasonable 2.2% y/y. But with global demand set to slow and a precarious consumer, the current growth rate looks unsustainable.

No income means no spending in Japan

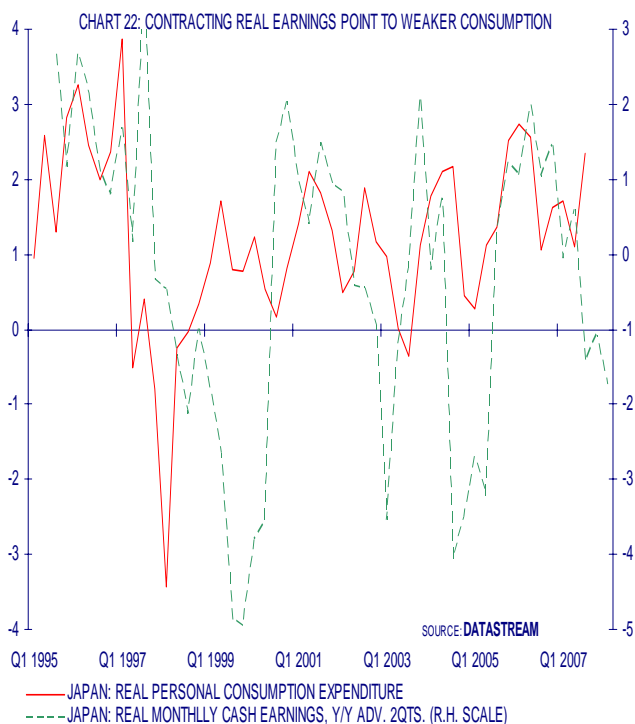
Foreign investors in Japanese assets hoped throughout 2007 that the consumer would recover after years of lacklustre growth. Bond managers took bets that inflation would rise while equity investors and asset allocators bought equities under the assumption that higher domestic spending would drive earnings higher. Their reasoning was not completely misplaced. The unemployment rate had fallen to its lowest level since before the Asian crisis, the jobs-to-applicants ratio reached a record high and consumer confidence was booming. But the devil was in the detail.

The number of part-time employees being hired by Japanese companies relative to full time has been rising steadily since the beginning of 2006. Generally, part time employment carries with it much less job security and lower remuneration and benefits. As a result, real wage growth began to slide in line with this trend and has not recovered since (Chart 21).

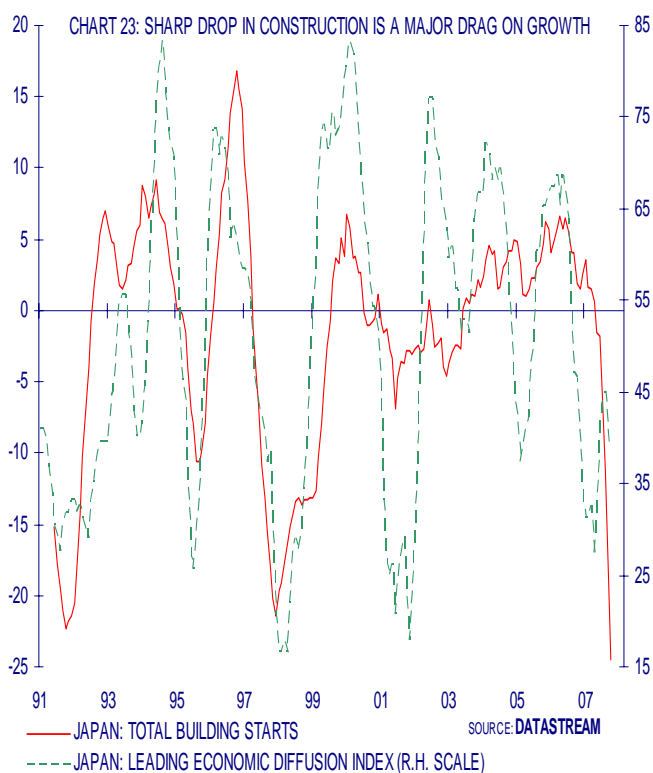


This trend combined with the increasing retirement of 'baby boomers' or those individuals between the ages of 55 and 65 means that the prospects for real disposable income growth, which has averaged 0.2% y/y since the Asian crisis, remains bleak. At the same time, the unemployment rate has begun to rise whilst

corporate expectations as measured by surveys have turned decisively more negative. The combination of all these factors will mean that any hopes of a recovery in Japanese household consumption are misplaced at this juncture (Chart 22).



Turning away from the consumer the picture doesn't look much better. New government laws on construction projects, which make the approval process more cumbersome, have caused construction starts to collapse (Chart 23). The drag is set to continue for at least two more quarters. The government's constrained finances mean that any significant increase in government spending from the current 0.5% y/y average growth rate (Q107-Q307) will be hard to come by. About the only sector that should hold in is exports which should continue to benefit from the Asian and Middle Eastern investment boom unless, of course, the U.S. dips into recession. Thus, with a poor outlook for 2008 and the Japanese economy likely to remain in mild deflation, the Bank of Japan will keep rates on hold at 0.5% this year.

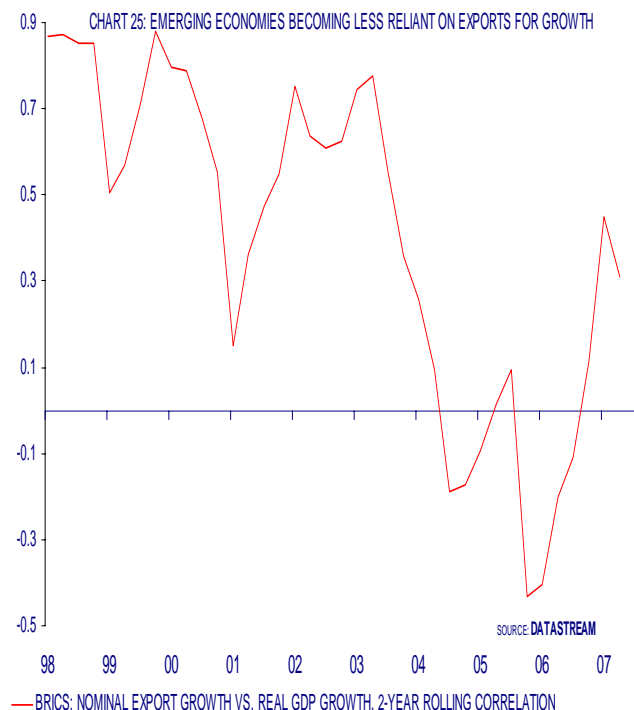
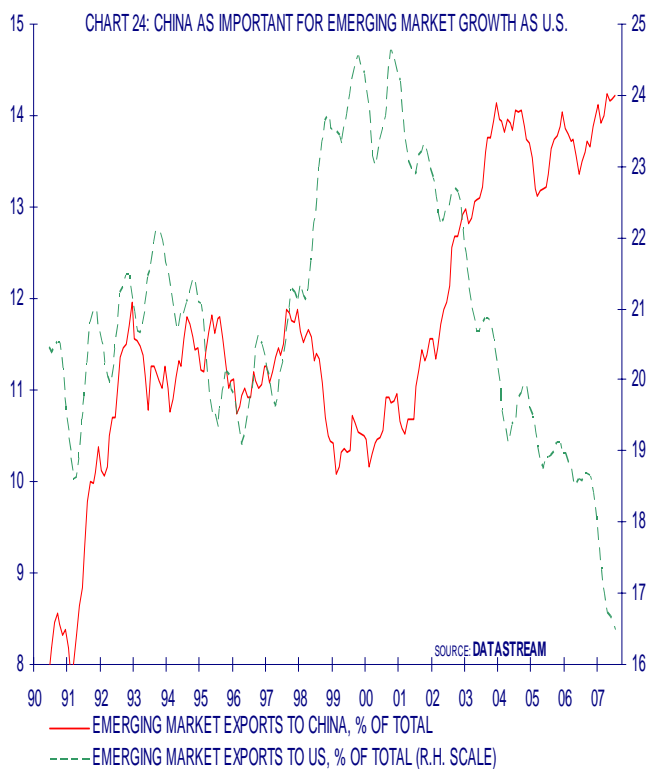


Chinese and EM growth to remain robust

China and the emerging markets have been riding the wave of strong investment spending and a robust global economy over the last few years. Though the outlook for developed market growth has become more precarious, emerging economies should continue to perform well, only slowing slightly as exports weaken.

The investment boom underway in parts of Asia, the Middle East, Central and Eastern Europe and Latin America looks set to continue. A low base level of infrastructure and ample liquidity comprise a constructive environment to engage in long term capital investment. The demand generated by this investment boom has meant that EM countries have increasingly diversified their export bases away from western countries and toward the emerging markets (Chart 24) which means that they have also become more resilient. But there are further knock on effects. As a result of booming investment and exports, emerging market real disposable income growth has also increased which has driven stronger household consumption. This dynamic has led to a virtuous cycle which has increased EM's insulation from the global growth/commodities cycle by decreasing their reliance on exports for

growth (Chart 25) which has been dubbed by many as 'global growth decoupling'.



Going forward, emerging economies will slow slightly as aggregate global demand eases and thereby tempers demand for their exports. However, the virtuous cycle of strong

investment, rising household disposable income and increasing consumption means that the emerging economies should continue to grow at a reasonable clip, around 6% y/y. If the U.S. were to go into recession, which is not our base case scenario, then the 'decoupling' argument would become more tenuous.

Conclusions

In sum our outlook is for a soft landing in the global economy. Global growth will likely downshift from just over 5% y/y in 2007 to 4-4.25% in 2008 on continued strength from the emerging markets. Inflation is likely to remain sticky in the short term due to strength in food and energy prices, but should ease in the medium term as growth moderates. As a result, G7 central banks, led by the U.S. Federal Reserve will be able to cut policy rates and avoid a recession. This scenario should allow for further steepening of global yield curves. As well, equities should continue to grind higher though not as smoothly as before. Commodities should also remain well bid as the emerging market investment boom continues.

Among the risks to this outlook are a sharper slowing of the U.S. corporate sector leading to a retrenchment in the U.S. consumer which would likely cause a recession. Another risk is that inflation remains high for longer than the short term which would impede central banks from cutting rates enough to maintain healthy growth. In this respect, the Eurozone is at risk as wage negotiations covering a large number of workers get underway in 2008 at a time when prices for essential goods such as energy and food remain elevated.

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