

**MANAGEMENT DISCUSSION SECTION****Company Representative**

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Welcome to Financial Research Perspectives with FactSet. Today, we will be speaking with Andy Harvell, Director of Quantitative Indexes at FTSE's Research and Development Group.

Today, Andy will be speaking to us about the current economic state of the UK market and how investigating index performance can lend insight into the economy in this region, as well as addressing current topics such as the impact of nationalization on the UK banks.

Join us again next Wednesday as we continue this conversation to include a discussion of cap bias and sector performance in this market.

Hi, Andy, thank you for so much joining us today.

**Andy Harvell, Director of Quantitative Indices, FTSE Group**

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Hi, Michelle.

**Company Representative**

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So, the first thing I wanted to talk about was just to get your idea of an economic overview for the UK market, now as well as six months ago perhaps. Can you give us sort of an overview of what's been going on in this space that's been interesting to you?

**Andy Harvell, Director of Quantitative Indices, FTSE Group**

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Well, basically what's been happening over the last six months is we've seen unemployment in this country continuing to rise, although the pace is actually slowing as the recession over here continues. With interest rates at an all-time low and the quantitative easing that was introduced to try and get the economy moving appears to be starting to have a little bit of an effect. Six months ago, there wasn't any signs of any green shoots or anything, whereas now we're beginning to see small increases in banks beginning to lend money again and easing credit.

Talking about the quantitative easing that's been going on, in previous times, obviously, the way to try and get an economy moving and bank lending again was to cut interest rates. And the theory behind this is to try and encourage people to spend and not save.

Now, the UK government, at the end of 2008, cut VAT to try and encourage people to spend. This didn't really have very much effect because it was seen to be on the wrong side. People wanted money in their pockets rather than money off goods. So it had a very limited effect.

And unfortunately, at the end of this year, the VAT increases again, so that could have a dampening effect on the economy again. But going back to the quantitative easing and the way it's worked, the economy was still shrinking and I believe it's still predicted to shrink for the rest of this year and drastic action was needed on that front. So Bank of England decided to pump money directly into the system by the process known as quantitative easing. And the Bank expanded the amount of money in the system by 125 billion.

They did this by buying up [inaudible], such as government and corporate bonds, and using money that is simply created out of thin air. This was just an electronic transaction as far as it was concerned.

The institutions selling those assets via the banks and the insurance companies, etcetera, will then have money in their accounts, which then boost the money supply. The idea was that the banks would then lend the money out to you and I and businesses to try and get the economy moving again. And although this wasn't actually physically printing money, an economist would argue that it's same principle, as it's a deliberate expansion of the bank -- Central Bank's balance sheet and the monetary base.

Now, bearing in mind, this has been not tried in this country before, but similar things, printing money, were tried in the past. Zimbabwe is an example and the old Weimar Republic, which ended up having hyper-inflation, so not a good scenario to happen. There is a lot of risk evolved.

Initially, the Bank was buying up bonds and gilts maturing between five and 25 years, but it said it would increase the range of instruments it was buying up. And it used the process of conducting reverse auctions where sellers competed to drive down prices on Mondays and Wednesdays. The auction was to process two facts, really. First, channel through the direct Central Bank's bank accounts, i.e., more money in their accounts, more money to lend out; that was the theory. And the second was to cut the cost of borrowing. When the [inaudible] with the scarcity of bonds, it meant that prices were rising and the yields were falling, and that meant that the interest rates were falling as well.

Having taken shorter term rates as low as possible, the idea was then for the banks to push down longer rates, which obviously are what mortgages are based on and what industry borrows at. If quantitative easing, which seems to work, which it has started working and credit growth would pick up and businesses would find it easier to get credit, which in turn would stimulate the economy.

As we've seen in this country, lots of businesses have gone bust, not because they were not profitable, but they couldn't get the working capital, which has had a major effect on quite large slices of the country where they were fairly industrially based and the companies couldn't get their working capital even to pay their staffs. We're starting to see slightly positive effects coming through now.

Paul Fisher, who is the member of the MPC, Bank of England's MPC, said that three months ago there is little evidence that QE was working. However, he said that now there seems to be having some effect, although unemployment was obviously still a problem. But as I said earlier on, the unemployment -- speed of unemployment increase is going down. So that's good news. The only thing at the moment is we don't know how long the quantitative easing is going to last for. And that in turn, if it goes on for too long, can cause more uncertainty in markets. The big danger at the moment for the UK, as some commentators have said, is that we end up having a double debt, which is not very good for anybody.

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**Company Representative**

Can you tell me a little bit about how the economy has been doing in terms of a perspective from looking at some of the major indices in the region?

**Andy Harvell, Director of Quantitative Indices, FTSE Group**

Well, if you look at the banks, for example, we had several banks merging, having false mergers last year, and some being even nationalized completely or part nationalized, whereas in the U.S. we had Lehman going to the wall, which actually precipitated the credit crisis.

This year, we're seeing that the banks are actually picking up. There has been more confidence. They are starting to lend. We're seeing banks as one of the biggest -- the best performers this year. The whole of the UK market is up. The FTSE 100 I believe is up about 40% this year. And over the last quarter, we had the FTSE 100's best performance ever and it was up 20%, which is a fantastic return given the fact that, the beginning of the year, there was very little confidence around and people were very worried. And we can see, for example, that over a 12-month period -- we can see that, for example, the banks have returned 14% over the last quarter. Over the year, 12-month period, they're down 20% with no total return value at the moment because they're not paying any dividends and not likely to for the foreseeable future.

However, confidence seems to be running right at the moment with Lloyd's Group announcing a rights issue. One of the things that banks want to do obviously is to get rid of the government stakes because they don't like the interference that the government puts on decisions that they make. Over in the UK, the banking bonuses situation is a hot topic at the moment, and along with U.S. banks -- some U.S. banks have actually reported really good quarterly figures. The subject of banks' bonuses and excesses seems to have come back on to both the political and the general public's radar scope again.

The UK government is now warning that excessive banking bonuses will not be tolerated. And that's obviously one reason why banks would like to pay off the government stakes so that the government doesn't have so much influence on them.

**Company Representative**

So you began to talk a little bit about government control or bearing on the UK banks. Can you talk a little bit more about that in the discussion of -- obviously earlier this year, a lot of what we were seeing was that the blogs and the news pages were rampant with this discussion of the nationalization of the UK banks. And maybe you can give us a little bit of an update on what kind of arose from these concerns and what the status of that is now?

**Andy Harvell, Director of Quantitative Indices, FTSE Group**

Well, interestingly, two of the major banks, HSBC and Barclays, actually managed to rebuild their balance sheets by raising funds privately. Barclays managed it through, again, a Middle Eastern investor involved, and HSBC did it through a rights issue. So we've now got this situation where we've got Northern Rock, which actually precipitated part of the problem, as a fully nationalized bank and Lloyd's Banking Group and Royal Bank of Scotland is being majority owned by the UK government via the UK, I think it's called the investment fund. Now, the banks themselves obviously want to raise their own funds to pay off the government stakes and to build up their balance sheets again. So that obviously in turn affects the cost of borrowing, because they want to increase their margins so that they can basically rebuild their balance sheets. And one of the issues is being with go to the market for right issues. The market hasn't been overly -- had a good appetite for them raising funds because they're worried about the financial situation.

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FDS  
Ticker▲

Financial Research  
Perspectives - Andy Harvell  
of FTSE Group - Part 1  
Event Type▲

Nov. 5, 2009  
Date▲

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All right, thank you very much, Andy. Thank you for listening. Next week on the podcast, we'll be following up with part two of our discussion with Andy Harvell as he highlights a sector-by-sector look at the UK market performance and discusses the possibility of a cap bias emerging in the major UK indices. He will also address the performance of the UK markets on a more granular level. In FactSet, you can access many of FTSE's major indices, including the FTSE 100, for your markets and economic analysis needs. Don't forget to rate and comment on our podcast in iTunes. We appreciate your feedback, and you can e-mail us at any time at [podcasts@factset.com](mailto:podcasts@factset.com). That's [podcasts@factset.com](mailto:podcasts@factset.com).

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