

HORIZONS

Monthly Outlook



January 2009

MARKET REVIEW

KEY THEMES

MARKETS AT A GLANCE

THE VIEW FROM LEGG MASON

Market Review: Modest up tick in December

As both governments and central banks continued to take extraordinary measures to shore up the global economy, most major equity markets recovered slightly in December, although nowhere near enough to make up for their substantial losses earlier in the year. In terms of sectors, with the exception of energy, which declined over the month, they all posted positive returns. The up-tick at the end of the year, albeit meagre, did renew hopes that markets had fully priced in the recession and had begun looking beyond the current economic conditions.

In bond markets, meanwhile, non-government bonds outperformed Treasuries in the US over the month. However, in the eurozone and the UK, non-government bonds continued to struggle. The Federal Reserve (Fed), European Central Bank (ECB) and the Bank of England (BoE) continued to slash interest rates and the US in particular saw further developments in terms of fiscal stimulus.

Key Themes

GLOBAL BONDS

Non-government bonds offer significant medium- to long-term opportunities

US EQUITIES

2009 to be tug-of-war between the challenging near-term outlook and long-term potential

EUROPEAN EQUITIES

Despite the challenging economic backdrop, value can be found selectively

ASIA-PACIFIC EQUITIES

Investment opportunities in those stocks that respond to Asian domestic demand

JAPANESE EQUITIES

Valuations for banks and real estate now look more attractive

EMERGING MARKETS EQUITIES

Looking for markets with sturdy domestic demand and the least dependence on net exports for growth

Markets at a glance

	Month	1 Year
MSCI World Index	3.20%	-40.71%
S&P 500 Index	1.06%	-37.00%
MSCI Europe ex-UK Index	9.22%	-45.54%
FTSE All-Share Index	3.67%	-29.93%
MSCI Asia ex-Japan Index	7.80%	-52.23%
MSCI Emerging Markets Index	7.80%	-53.33%
MSCI Japan Index	8.13%	-29.21%
BARCLAYS CAPITAL Global Aggregate Index	6.12%	4.79%

All returns are in US dollar terms as at 31 December 2008. Source: Legg Mason.

Global Equities

GLOBAL CURRENTS INVESTMENT MANAGEMENT

Global Currents Investment Management observes that despite the current gloomy economic backdrop, history suggests that equity markets often rebound well in advance of the end of any recession, and often the gains can be quite significant. It anticipates that economic growth will be difficult to generate in most developed markets in early 2009 and observes that the global contraction in economic activity and the risk of deflation will provide further impetus for central bank rate cuts in Europe and Asia while the US has already effectively moved rates to zero. However, the manager thinks that fiscal policy actions and other initiatives planned by the new US president could be beneficial if actions are taken swiftly and executed correctly. Indeed, it believes that markets have already begun to 'normalise'. As a result, the manager is currently optimistic about the prospects for certain global companies, in particular those with strong profits and dividends, and healthy balance sheets.

Global Fixed Income

WESTERN ASSET MANAGEMENT

The manager says it is difficult to forecast when the current process of deleveraging will end or when liquidity will return to the market place, but it believes that policymakers in most countries seem determined to avoid erring on the side of doing too little. The Fed is essentially printing money and channelling it directly to the housing market to help arrest the decline in home prices.

The BofE has slashed rates to the lowest level ever (in January) and has recently begun contemplating less traditional measures such as quantitative easing. In the eurozone, policymakers have dragged their feet. However, given deteriorating economic conditions, the manager expects further significant rate cuts by the ECB.

The manager believes policymakers are likely to be successful in restoring a degree of stability to the global financial system. Once liquidity conditions improve, it believes the pricing of riskier asset classes should stabilise. And although economic conditions are likely to remain difficult for the next few years, the manager believes there is a profitable opportunity for investors with a medium-to-long-term horizon. The market has priced in a deflationary economic scenario for years to come. Anything less catastrophic would be positive for investors with a bias away from government debt.

Against this backdrop, the manager believes investment grade and high yield corporate bonds, as well as securitised debt, should perform particularly well. It is looking to maintain its focus on select European financials that were less exposed to asset price bubbles. It will also continue to focus on mortgage-backed securities, as agency bonds in particular offer attractive value given the Fed's buying programme.

US Equities

LEGG MASON CAPITAL MANAGEMENT

The manager believes that it is increasingly likely that November the 20th, 2008 marked the bottom of this bear market cycle for the major indices such as the S&P 500 Index. Having said this, it expects 2009 to be a tug-of-war between the near-term outlook – which will continue to be very challenging – and the long-term investment opportunity offered by stocks at present, which the manager believes is quite substantial. Ultimately, it expects this tug-of-war to be resolved on the upside and the S&P 500 could be up 25% to 30% for the year. Although this might seem extreme, the manager notes that such gains would do nothing more than return those indices to the ranges in which they traded as recently as September 2008.

In terms of positive developments supportive of this scenario, the manager observes that credit markets have begun to free up and credit spreads have started to narrow. Junk bonds have enjoyed a spirited rally since mid-December. Investment grade bonds have also begun to act better. This, the manager observes, is a necessary precondition to a sustained improvement in the stock market and the economy. Elsewhere, the TED spread, which is a good indication of banks' willingness to lend to each other, is down to its lowest level since the collapse of Lehman Brothers. And finally, the Volatility Index (VIX), often referred to as the "Fear Index", has come down from the stratosphere. All of these developments, the manager concludes, are good news for the economy and the stock market.

European Equities

BATTERYMARCH FINANCIAL MANAGEMENT

The Fund's investment manager notes that data released in December indicated a slowdown in European lending growth from October to November, due to a combination of tighter credit and sagging demand. The ECB announced a 0.75% reduction in interest rates, the largest single cut in the eurozone's 10-year history, bringing rates down to 2.5% in early December. Meanwhile, a drop in German inflation for the month suggested that the inflation rate for the eurozone as a whole will be within the ECB's target range, giving it more flexibility in terms of interest rate decreases. However, room for additional cuts is very limited, according to the central bank, but the manager notes that some

observers believe rates will drop another 0.50% in January (which they subsequently did). Despite the challenging economic backdrop, the manager continues to believe that value can still be found on a selective basis in Europe's equity markets.

Asia-Pacific Equities

BATTERYMARCH FINANCIAL MANAGEMENT

The manager believes that it can continue to find investment opportunities that respond to domestic demand in Asia. It notes that public and private capital is supporting significant infrastructure projects in India and China, and these investments, along with growing domestic consumption, help provide some protection from the drop-off in demand from the US and other developed markets. The manager's bottom-up stock selection model currently points towards large-cap firms with quality management, as the model is signalling that these currently present some of the best value.

The manager also notes that emerging markets still offer better expected earnings growth than the developed markets, despite falling estimate revisions, as well as better profitability. The manager believes that the backdrop of attractively valued currencies, strong foreign reserve positions, and strong domestic consumption in many emerging market countries, continues to provide a supportive environment for corporate earnings and this should help companies to weather the current global financial market turmoil.

Japan Equities

LEGG MASON INTERNATIONAL EQUITIES, SINGAPORE

Looking ahead, the investment manager believes that as we head into a new year the Japanese equity market does not appear to be on the cusp of a major rally, given continued heightened concerns of a global recession. All the same, the manager believes that an overly defensive portfolio position is no longer appropriate, noting that Japan's lost decade has demonstrated that the stock market can turn around with appropriate policy responses in spite of growing deflationary expectations. With significant global policy initiatives underpinning expectations of a market recovery in 2009, the manager favoured the selling of defensive names. These helped to fund new positions in the financials sector, for example, where the manager feels that valuations for banks and real estate now look more attractive.

“We favour markets and stocks whose earnings profile will prove the most resilient to the economic crisis.”

Legg Mason International Equities,
Singapore

Emerging Markets Equities

LEGG MASON INTERNATIONAL EQUITIES, SINGAPORE

Against the outlook of heightened uncertainty and slumping global demand, the investment manager favours markets and stocks whose earnings profile it believes will prove the most resilient to the economic crisis, and whose balance sheets are robust enough to weather tighter access to credit while at the same time offering attractive valuations. It believes that stocks with these characteristics tend to be found in markets with sturdy domestic demand and the least dependence on net exports for growth. Hence the manager holds overweight positions in Brazil, Mexico, Turkey, Russia, India and Thailand. A similar line of thought leads it to be cautious towards the large export-dependent countries in Asia, particularly Korea and Taiwan, in which it has the largest underweight positions.

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Issuer: Legg Mason Asset Management Hong Kong Limited.