

HORIZONS

Monthly Outlook



February 2009

MARKET REVIEW

KEY THEMES

MARKETS AT A GLANCE

THE VIEW FROM LEGG MASON

Market Review: Markets experience a bitter January

After showing early signs of recovery in December, global equity markets reversed again in January and the MSCI World Index ended the month down over 7% in local currency terms. The U.S. in particular had a difficult month, with the S&P 500 Index experiencing its worst January on record. To add to the stock market's woes, fresh economic data showed the largest contraction in U.S. output since the early 1980s. Corporate news too was unsettling, with many companies producing poor results.

In terms of fixed income investors, there were some signs of improvement in financial markets during January, indicating that monetary stimulus and bank recapitalisation efforts were having a positive impact. Nevertheless, underlying economic conditions continued to deteriorate, with fourth quarter GDP figures posting the worst declines in decades, and policy makers increasing their level of support for financial markets and the economy. As strains in the financial system eased, non-government bonds generally outperformed their government counterparts.

Key Themes

GLOBAL BONDS

Investment-grade bonds relatively attractive

US EQUITIES

By post-WWII standards of valuation, today's market appears undervalued for long-term investors

EUROPEAN EQUITIES

Despite the challenging economic backdrop, value can be found selectively

ASIA-PACIFIC EQUITIES

Asia, led by China, is expected to provide much of the global economic growth for 2009

JAPANESE EQUITIES

Policy responses are key

EMERGING MARKETS EQUITIES

Looking for opportunities that respond to domestic demand

Markets at a glance

	MONTH	YEAR TO DATE	1 YEAR
MSCI WORLD INDEX	-8.76%	-8.76%	-41.43%
S&P 500 INDEX	-8.43%	-8.43%	-38.63%
MSCI EUROPE EX-UK INDEX	-13.16%	-13.16%	-46.78%
FTSE ALL-SHARE INDEX	-8.55%	-8.55%	-47.61%
MSCI ASIA EX-JAPAN INDEX	-5.40%	-5.40%	-47.56%
MSCI EMERGING MARKETS INDEX	-6.46%	-6.46%	-50.12%
MSCI JAPAN INDEX	-6.80%	-6.80%	-30.86%
BARCLAYS CAPITAL Global Aggregate Index	-3.27%	-3.27%	-1.38%

All returns are in US dollar terms as at 31 January 2009. Source: Legg Mason.

Global Equities

GLOBAL CURRENTS INVESTMENT MANAGEMENT

The investment manager says that its outlook is optimistic given that the world still has huge, unmet needs that represent significant long-term growth potential for investors. Also, it recognises that the current negative sentiment in the market has the same forecasting significance as the former boom market that was in place before the current crisis. From the depths of plunging earnings and the impact of recession, it is seeing indications of a new value cycle. As earnings are rebased and become priced into securities, it believes that prudent investors can capitalise on solid opportunities for quality firms with strong profits, high and growing dividends and strong balance sheets. It is favourably inclined to invest in cyclical companies that have been punished but exhibit low expectations and great value. The manager is cautiously evaluating financials, which have started to deleverage, albeit too slowly, and so the process is likely to continue. Elsewhere, its research analysts are evaluating opportunities in the consumer discretionary, basic materials, healthcare and technology sectors – currently available at attractive valuations. Despite the losses of the past year, history reflects that equity markets often rebound well in advance of a recession's end, with performance gains that are typically significant. It therefore anticipates that investors who stay the course may benefit going forward.

Global Fixed Income

WESTERN ASSET MANAGEMENT

The investment manager expects economic activity to remain weak for some time, but believes that the extra-ordinary policy efforts implemented in recent months should restore stable albeit meagre growth by the second half of 2009. A challenged equity market, corporate defaults, rating down-grades and continued illiquidity are likely to cause further volatility in bond markets in the short term. However, the manager is encouraged by the rapid improvements it has observed in funding and credit markets since the turn of the year.

The manager continues to focus on non-government bonds and believes that investment grade corporate bonds currently offer some of the best opportunities in fixed income. Valuations in the sector reflect a level of defaults that has never been experienced and that the manager thinks is unlikely to be realised. In addition, corporate balance sheets are relatively sound despite the weak economic backdrop. The manager also continues to believe that subordinated issues within the financial sector offer compelling valuations. Indeed, it believes the market has overreacted and that pricing on many of these instruments reflects highly unlikely scenarios. Elsewhere, it believes that mortgage-backed securities (MBS) issued by Fannie Mae and Freddie Mac continue to look attractive, given the Fed's purchase programme. However, as MBS prices are gradually driven higher by these purchases, the manager will look to take profits and reinvest them in investment grade corporate bonds.

US Equities

LEGG MASON CAPITAL MANAGEMENT

The investment manager observes that the market continues to be quite volatile and has not got off to the start it had expected. It appears that the market-bottoming process that it thinks began in October 2008 may have several more months to run. Whether the market has meaningful downside from here depends on what one's standard for undervaluation is, in its view. Its traditional frame of reference has been the post-World War Two (WWII) era: first, because it represents a period of over six decades; second, because the body of economic and market data for that period is quite robust; and third, because the U.S. economy has been more service-based in the post-WWII era than previously and, thus, valuation comparisons between the pre- and post-WWII eras seemed less relevant to present circumstances. By post-WWII standards of valuation, it thinks today's market is significantly undervalued.

European Equities

BATTERYMARCH FINANCIAL MANAGEMENT

The investment manager notes that data released in December indicated a slowdown in European lending from October to November, due to a combination of tighter credit and sagging demand. The European Central Bank's (ECB) 0.75% reduction in interest rates in December was the largest single cut in the eurozone's 10-year history. 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, which many observers believe should give it more flexibility in terms of interest rate decreases. Although until only recently the central bank believed that room for additional cuts was very limited, rates were reduced another 0.50% in January. Despite the difficult backdrop, the investment manager continues to believe that value can still be found in European equity markets, and as a disciplined, long-term investor it continues to seek attractive stocks regardless of the environment.

Asia-Pacific Equities

BATTERYMARCH FINANCIAL MANAGEMENT

The investment manager believes that although the larger Asian countries tend to be more susceptible than other emerging markets to the global economic slowdown due to their trading partnerships, the outlook for Asia remains positive.

Asian countries are typically net commodity users and the decline in prices benefits their current account balances, further bolstering their reserves as well as their fiscal and monetary flexibility. These countries have the means to implement economic stimulus measures through interest rate reductions, fiscal stimulus and other qualitative initiatives to sustain domestic growth. The manager adds that it expects Asia, led by China, to provide much of the global economic growth for 2009.

In past periods of negative, sentiment-driven volatility, the manager has experienced relative underperformance and negative results from its stock selection model, similar to those seen during the fourth quarter of 2008. As risk appetite returns, however, it expects that good companies will again be rewarded and that its stock selection process should add value.

Looking ahead, the combination of compelling valuations, superior growth prospects and solid balance sheets at the sovereign, corporate and household level, leads the manager to remain confident in the capacity of the Asia ex-Japan region to perform well in the long term.

Japan Equities

CONGRUIX INVESTMENT MANAGEMENT

The manager continues to believe that an overly defensive portfolio position is no longer appropriate, as Japan has demonstrated in the past that its stock market can turn around with appropriate policy responses in spite of growing deflationary expectations. As previously noted, the manager has tweaked its strategy with moves that include the sale of defensive names in order 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. The manager's base case is that the significant policy initiatives that are taking place on a global basis should be sufficient to underpin expectations of a market recovery in 2009.

"We remain confident in the capacity of the Asia ex-Japan region to perform well in the long term."

Batterymarch Financial Management

“We believe emerging markets still offer superior earnings growth, despite downwards-trending estimate revisions, and better profitability than their developed markets peers.”

Batterymarch Financial
Management

Emerging Markets Equities

BATTERYMARCH FINANCIAL MANAGEMENT

The investment manager notes that although emerging market equities have returned to their historical valuation discount to developed market equities, they still offer superior earnings growth, despite downwards-trending estimate revisions, and better profitability than their developed markets peers. The manager continues to find what it believes are investment opportunities that respond to domestic demand. It 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 should help them to weather the current global financial market turmoil.

The manager also notes that emerging markets remain undercapitalised. Emerging economies represent more than 80% of both world population and land mass, nearly 70% of foreign reserves, more than 50% of GDP (measured at purchasing power parity) but still only 10% of global market capitalisation. The manager expects that emerging capital markets should continue to grow both through prices and eventually new equity supply to reflect this superior growth potential.

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