HORIZONS
Monthly Outlook

March 2009

MARKET REVIEW

KEY THEMES

MARKETS AT A GLANCE

THE VIEW FROM LEGG MASON

Market Review:
Markets catch a cold in February sell-off

February was another challenging month for equity markets and left investors extremely concerned about the environment so far in 2009. Capital markets have been rattled by the sharpest global economic downturn since World War II. Investors' nerves have been frayed by a combination of factors including deteriorating earnings across both financial and non-financial sectors, the severity of the global recession, and continued volatility in the capital markets. In general, the pain for investors was spread across both large-cap and small-cap stocks as well as domestic and international securities. Consumers have been worried about their jobs, rising debt and the decline of personal wealth. The U.S. Government launched its multi-trillion dollar Financial Stability Plan to reinforce credit markets, create jobs, and bolster consumer and business confidence. Despite this action by the U.S., as well as central banks and governments around the globe – credit markets remained strained and the global economic slow down continued driving equity markets to historic lows.

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 markers 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 currently offer some of the best opportunities

US EQUITIES
Once the market bottoms, the upside could be considerables

EUROPEAN EQUITIES
Cautious optimism as European Central Bank signals 2010 recovery

ASIA-PACIFIC EQUITIES
Compelling valuations, superior growth prospects and solid balance sheets

JAPANESE EQUITIES
Domestic-oriented companies present attractive opportunities

EMERGING MARKETS EQUITIES
Continuing to offer better expected earnings growth than developed markets

CHINA EQUITIES
Market-leading companies spearheaded by seasoned management team offer greater potential

Markets at a glance

	MONTH	YEAR TO DATE	1 YEAR
MSCI WORLD INDEX	-10.24%	-18.10%	-47.12%
S&P 500 INDEX	-10.65%	-18.18%	-43.32%
MSCI EUROPE EX-UK INDEX	-11.08%	-22.78%	-53.68%
FTSE ALL-SHARE INDEX	-7.58%	-12.73%	-51.98%
MSCI ASIA EX-JAPAN INDEX	-6.51%	-11.55%	-53.68%
MSCI JAPAN INDEX	-12.38%	-18.34%	-39.84%
MSCI EMERGING MARKETS INDEX	-5.64%	-11.73%	-56.17%
MSCI CHINA INDEX	-3.17%	-11.21%	-49.76%
BARCLAYS CAPITAL Global Aggregate Index	-2.23%	-5.43%	-5.17%

All returns are in US dollar terms as at 28 February 2009. Source: Legg Mason.

Global Equities

GLOBAL CURRENTS INVESTMENT MANAGEMENT

The manager anticipates that economic growth will be a challenge for most developed economies in 2009. It believes the duration of the global slowdown will be mainly a function of the speed, impact, and magnitude of the economic stimulus. The U.S. government seems to be behind the curve, according to the manager, and in some ways, making some wrong turns. History indicates that more spending and more debt is not the cure for what ails a troubled economy. In contrast to the U.S. example, the manager favours the actions of China and other Asian countries. The Asian model, it observes, is focused on cutting taxes, raising incentives to invest and grow businesses, and deploying capital to education and investments – all part of a comprehensive strategy to support productivity and income growth areas. Notably, the U.S. is focused instead on redistribution of income, higher taxes, more regulation and bigger government – all factors that are not likely to create a sustainable economic recovery or foster a more solvent financial system. The manager believes that the solution requires a combination of monetisation or quantitative easing (dollars being printed) coupled with real deleveraging (capital moves from weaker to stronger hands). Notwithstanding some concerns about fiscal policy, these processes are being initiated in the U.S., Great Britain and other countries – a development that in its opinion is favourable looking forward.

Global Fixed Income

WESTERN ASSET MANAGEMENT

The manager continues to believe that weak economic fundamentals are more than accounted for in current valuations in bond markets and that patience will be rewarded over the longer term. Continued stress in the financial and housing sector could depress markets in the short term. Meanwhile, even a fragile stability in underlying economic conditions would be very positive for most non-government bond sectors and could lead to significant outperformance over government debt.

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. Indeed, the manager is looking to gradually shift exposure away from agency mortgage-backed securities (MBS) towards investment grade corporate bonds. While the manager believes that agency MBS still offer attractive valuations, the asset class has outperformed corporate debt significantly in the past six months, supported by the U.S. Federal Reserve's purchase programme.

US Equities

LEGG MASON CAPITAL MANAGEMENT

The manager observes that the market the U.S. equity market has discounted an enormous amount of bad news. However, it wonders whether it has discounted the worst that we are likely to see? At the beginning of the year, the manager thought that it had. Now it is honestly not sure. While it remains firmly bullish on the longer-term outlook for equities, it acknowledges that the range of near-term outcomes is unusually wide at present. Once the market finds a bottom, the manager believes that the upside could be considerable, even over the next 12 months, and certainly over the next three to five years. Now that the 20 November 2008 lows – that it thought would hold, but didn't – have been breached, it believes we need a new yardstick for calibrating the downside risk. Using its own framework, the manager thinks a reasonable worst case for the S&P 500 Index is a further decline to the low 600s.

European Equities

BATTERYMARCH FINANCIAL MANAGEMENT

Europe (ex UK) was one of the poorest performing equity markets in February. Indeed, data indicating a 1.5% contraction in the eurozone economy during the fourth quarter helped to put pressure on the European Central Bank (ECB) to reduce interest rates, which it subsequently did in early March. Nevertheless, Jean-Claude Trichet, head of the ECB, announced that he expected an improvement in economic activity next year. Against this challenging backdrop, the manager remains cautiously upbeat about the outlook for Europe and is modestly overweight in its portfolios.

Asia-Pacific Equities

BATTERYMARCH FINANCIAL MANAGEMENT

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 manager believes the long-term outlook for Asia remains positive. It observes that 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, the manager notes, have the means to implement economic stimulus measures through interest rate reductions, fiscal stimulus and other qualitative initiatives to sustain domestic growth. It therefore expects Asia, led by China, to provide much of the global economic growth for 2009.

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[1]

Looking ahead, the manager believes that the macroeconomic outlook remains fraught with uncertainty. It thinks that a potential blow out in Eastern Europe, the lack of clarity on U.S. regulators' approach to the banking problems as well as rising political risks in Japan means that the market will stay volatile. In this environment, it continues to seek out companies that are taking proactive steps to ensure that they emerge stronger from this crisis. This is because the manager believes that companies that have permanently reduced their cost base, liquidated their working capital to cash as well as de-levered their balance sheets, are well positioned to engineer an earnings recovery.

Emerging Markets Equities

BATTERYMARCH FINANCIAL MANAGEMENT

The investment manager believes that emerging market economies are in far stronger positions to weather the global downturn than in previous such environments. This is because governments have reacted to the current market environment with significant policy initiatives intended to spur future growth, including interest rate cuts and stimulus packages.

The manager continues to find investment opportunities, particularly in Asia. Public and private capital is supporting significant infrastructure projects in India and China, it notes, and these investments help provide some protection from the drop-off in demand from the U.S. and other developed markets. The manager adds that large-cap firms with quality management are presenting some of the best values today. More generally, it says that emerging markets still offer better expected earnings growth than the developed markets, despite falling estimate revisions, as well as better profitability. The backdrop of attractively valued

"We remain confident in the capacity of emerging markets to outperform in the long term."

Batterymarch Financial Management

[1] Congruix Investment Management (a registered business of Legg Mason International Equities (Singapore) Pte. Limited).

currencies, strong foreign reserve positions and strong domestic consumption in many emerging market countries continues to provide a supportive environment for corporate earnings.

Looking ahead, the combination of newly compelling valuations, superior growth prospects and solid balance sheets, both at the sovereign and the company level, leads the manager to remain confident in the capacity of emerging markets to outperform in the long term.

China Equities

LEGG MASON HONG KONG ASSET MANAGEMENT[2]

China policy makers are likely to adopt a wait-and-see approach with regard to the introduction of further stimulus measures. Policy makers remain watchful on key macro economic data such as unemployment rate, consumer prices, monetary growth rates and property prices. At the recent close of the annual National People's Congress ("NPC") and the Chinese People's Political Consultative Conference ("CPPCC"), no new measures have been introduced.

Since March, Hong Kong and China companies have been reporting their 2008 results where declining profit growth and accentuated provisioning in the fourth quarter of 2008 are amongst the common features. Corporate managers are increasing their focus on strengthening their balance sheet and cash flow with a strong preference to reducing risk. Visibilities on sales and orders are low. As such, earnings progression in 2009 may be biased further on the downside. Given healthy balance sheet of local households and companies, a return of confidence in employment will help to improve domestic consumption and property asset prices.

Policy actions and regulatory changes from developed markets such as U.S. and Europe are creating new financial environment where access to capital will be more costly and limited. In such scenario, Hong Kong and Mainland companies should be least affected given their robust financial positions. We remain focus on selecting market leaders spearheaded by seasoned management team which will help these companies navigate through current uncertainties.

[2] Legg Mason Hong Kong Asset Management (operating under both Legg Mason Asset Management Hong Kong Limited and Legg Mason International Equities (Hong Kong) Limited).