

HORIZONS

Monthly Outlook



May 2009

MARKET REVIEW

KEY THEMES

MARKETS AT A GLANCE

THE VIEW FROM LEGG MASON

Market Review: April Rebound

Global equities extended their gains in April, after rebounding in late March, as risk aversion abated despite generally bleak economic news. Further policy action by central banks and governments around the globe, as well as positive signs on the Chinese economy, provided support to financial markets, leading investors to return to riskier asset classes. In the U.S., the Treasury's Public-Private Investment Program (PPIP), aimed at removing toxic assets from the banking system, helped to drive the equity market up from the lows reached in late March. The rebound in equity markets was broad-based across the globe, although emerging markets, and in particular Asia, outperformed the other regions for a further month. Returns over April exceeded an already strong performance in March, when emerging markets recorded their strongest month in more than 15 years.

The riskier sectors of global fixed income markets also benefited from investors' improved risk appetite, as investors began to consider worstcase scenarios as increasingly unlikely on the back of concerted policy action by central banks and governments. Non-government bonds continued to outperform government issues, with investment grade and high yield corporate bonds performing particularly well. Financials, and in particular subordinated Tier 1 debt, saw spreads over government bonds narrow significantly.

Key Themes

GLOBAL BONDS

Corporate bonds currently offer some of the best opportunities

US EQUITIES

May be in the early stages of a new bull market

EUROPEAN EQUITIES

The European Central Bank expects a gradual economic recovery in 2010

ASIA-PACIFIC EQUITIES

The Chinese economy in particular is showing some positive signs

JAPANESE EQUITIES

Companies that have seen sharp inventory depletion present opportunities

EMERGING MARKETS EQUITIES

Still offer better expected earnings growth than developed markets

CHINA EQUITIES

Marco outlooks are increasingly being upgraded

Markets at a glance

| | MONTH | YEAR TO DATE | 1 YEAR |
|--|--------|--------------|---------|
| MSCI WORLD INDEX | 11.22% | -2.04% | -39.33% |
| S&P 500 INDEX | 9.57% | -2.49% | -35.31% |
| MSCI EUROPE EX-UK INDEX | 14.56% | -4.05% | -45.36% |
| FTSE ALL-SHARE INDEX | 11.66% | 1.20% | -46.26% |
| MSCI ASIA EX-JAPAN INDEX | 16.77% | 17.54% | -39.38% |
| MSCI JAPAN INDEX | 9.63% | -8.60% | -34.57% |
| MSCI EMERGING MARKETS INDEX | 16.64% | 17.75% | -42.90% |
| MSCI CHINA INDEX | 11.08% | 12.56% | -37.26% |
| BARCLAYS CAPITAL Global Aggregate Index | 0.90% | -2.38% | -2.20% |

All returns are in US dollar terms as at 30 April 2009. Source: Legg Mason.

Global Equities

GLOBAL CURRENTS INVESTMENT MANAGEMENT

The manager notes that with economies in decline and credit markets still wobbly, earnings expectations may be vulnerable for many companies going forward. If earnings erosion continues, the implication for equity markets would be negative. Alternatively, positive earnings surprises going forward would bolster confidence and be a positive factor for markets. Continued uncertainty is likely to fuel volatility in the equity markets, which could bring significant swings in prices over short time periods.

The manager believes that government actions in the form of extraordinary monetary stimulus, along with fiscal stimulus, should provide a benefit to capital markets over time. It is encouraged that governments will continue to boost fiscal spending. However, an extended retrenchment by consumers and businesses in the form of hoarding cash, restrained spending, and a lack of growth and expansion by companies, could hobble economic growth going forward.

Despite these considerations, the manager is cautiously optimistic for the rest of 2009, believing that tangible signs of a recovery may be seen from a bottom-up perspective. Thematically, it believes that consolidation and efficiency will dominate in many sectors and the strongest firms will be able to capitalise on these trends. Its focus is to select firms that possess the key drivers of prosperity – strong balance sheets, high quality business models, stable cash flows and solid management.

Global Fixed Income

WESTERN ASSET MANAGEMENT

The manager continues to anticipate a tepid recovery in economic growth in most advanced economies later in the year. Indeed, a return of stability given sufficient government intervention has long been its belief. It is encouraged by recent signs that investors are beginning to revise down the probability of a deflationary economic scenario, but it believes it remains too early to claim that the business cycle has reached a bottom.

Under its base case scenario, whereby most advanced economies would record positive growth rates before the end of the year, both investment grade and high yield corporate debt should perform strongly. Even under its most pessimistic scenario, it believes that default risk is overestimated by the market and would therefore expect corporate bonds to outperform their government counterparts over the next few years. The manager continues to focus on nongovernment bonds and continues to look at gradually shifting exposure away from agency mortgage backed securities towards investment grade corporate bonds.

“We may be in the early stages of a new bull market.”

Legg Mason Capital Management

US Equities

LEGG MASON CAPITAL MANAGEMENT

The manager notes that there have been a number of encouraging developments in the last month on the economic, policy and regulatory fronts that gives it growing confidence that an important inflection point may be near, both in terms of the economy and the stock market. It believes these developments, together with the brutal market decline through early March that it believes discounted an enormous amount of bad news, have set the stage for the best rally in the market in over two years. Indeed, the manager thinks that we may be in the early stages of a new bull market, rather than just enjoying yet another bear market rally.

On the economic front, the manager thinks that the U.S. economy may have bottomed in the first quarter of 2009. On the policy front, we believe the Treasury's recently announced Public-Private Investment Program (dubbed “P-PIP” in Washington), designed to assist banks in removing legacy assets from their balance sheets, has a reasonably good chance of working. However, it is the recent regulatory changes with respect to mark-to-market accounting that it finds most encouraging.

European Equities

BATTERYMARCH FINANCIAL MANAGEMENT

The investment manager notes that there are clear signs that the economic slowdown in the eurozone is accelerating. The head of the European Central Bank (ECB), Jean-Claude Trichet, indicated when announcing the 0.5% interest rate reduction in early March that gradual economic recovery is expected in 2010. However, the ECB does expect both global and domestic demand to decline in 2009. Despite the very difficult backdrop, the manager remains cautiously optimistic on the outlook for European equities following their recent declines, and believes that value can still be found selectively in the region.

Asia-Pacific Equities

BATTERYMARCH FINANCIAL MANAGEMENT

The manager thinks that Asian markets are likely to remain volatile as long as uncertainty continues in global markets. However, it notes that their economies are generally in stronger positions to weather the global downturn than in previous such environments. Indeed, governments have reacted to the current market environment with significant policy initiatives intended to spur future growth, including interest rate cuts and stimulus packages. And the manager is encouraged by signs that the policy initiatives are beginning to gain traction. In China particularly there are positive signs, including recent positive Purchasing Managers Index readings and increased new bank lending.

Looking ahead, the combination of compelling valuations, superior growth prospects and solid balance sheets at the sovereign, corporate and household levels, leads the manager to remain confident in the capacity of Asian emerging markets to outperform in the long term.

Japan Equities

CONGRUIX INVESTMENT MANAGEMENT¹

Japanese economic data has remained dismal. Economists were forecasting a further 10.5% decrease in gross domestic product (GDP) over the first quarter, but indicated they saw downside risks to this number, as Japan incurred its first current account deficit in 13 years. The investment manager notes that the weak economic data has forced the government to step up deliberations on additional stimulus packages, even before the fiscal year 09 budget has been passed. The manager adds that even though the measures may remain inadequate, the government's sense of urgency has clearly risen. The investment manager recognises that there have been a couple of positive economic releases in the U.S. in recent weeks, but it is in no hurry to call a trend.

The manager continues to focus on its selected themes, one of them being inventory depletion. The manager aims to overweight select companies across multiple industries that have experienced massive but unsustainable drops in production levels and that should therefore see a near-term recovery in production and utilisation.

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

“There are positive signs, particularly in China, Brazil and Russia.”

Batterymarch Financial Management

Emerging Markets Equities

BATTERYMARCH FINANCIAL MANAGEMENT

The investment manager believes that the relative outperformance of emerging markets since late October indicates that at least some diversification benefits of holding the asset class remain. However, it expects that emerging markets are likely to stay volatile as long as severe uncertainty continues in global markets. The manager continues to believe that emerging market economies are generally in stronger positions to come through the global downturn than in previous such environments. Governments have reacted to the current market environment with major policy initiatives intended to encourage future growth, including interest rate cuts and stimulus packages. There are positive signs in particular in China, Brazil and Russia.

The manager also continues to believe 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 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 compelling valuations, superior growth prospects and solid balance sheets at the sovereign, corporate and household levels, 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 MANAGEMENT²

Markets have been re-rated upwards based on recent better than expected macro economic performances in China and selective positive corporate results albeit in the absence of earnings upgrades. While earnings are expected to contract in 2009 and revisions are still mildly biased to the downside, macro outlooks are increasingly being upgraded. Opportunistically, corporate managers are taking advantage of recent market rally to raise equity capital in order to reduce leverage ratio and improve cash balances. The bias is still towards strengthening their balance sheets. Looking out, any increase in corporates' capital expenditure or investments will indicate a preference in returning to growth mode and switching away from current defensive stance. Policy intervention remains a key driver to expectation on earnings over the next couple of years. While successive policy interventions have been welcomed by markets, the design and impact of these interventions are still biased towards quantity and not quality. Any improvement in pricing power and profit margins will help to boost the sustainability of current rebound. We remain watchful on these subtle changes and preferences.

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).

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Issuer: Legg Mason Asset Management Hong Kong Limited.