HORIZONS
Monthly Outlook

June 2009

MARKET REVIEW

KEY THEMES

MARKETS AT A GLANCE

THE VIEW FROM LEGG MASON

Market Review: Extending the Rally

Global equities had another strong month in May, extending the rally that started in March. Further policy action around the globe, as well as tentative signs of stabilisation in economic indicators in many of the developed economies, provided further support. In the US, the results of the much anticipated stress tests showed that the large US banks analysed by US regulators needed to raise less capital than feared. This helped to keep investor sentiment positive, fuelling further gains in equity markets and pushing other risk assets higher. Although the gains in equity markets were broad-based across the globe, emerging markets, and in particular Asia, continued to outperform the other regions, as investors realised that emerging market fundamentals have remained fundamentally strong throughout the global economic turmoil.

The riskier sectors of global fixed income markets continued to perform well over May, while government bonds generally recorded negative returns. The improving economic outlook and reduced concerns over the recapitalisation needs of financial institutions continued to boost investor confidence over the month. Within non-government bonds, the investment grade corporate sector in Europe and the US had another exceptional month, after the record performance seen in April. Financial issues led the rally, with subordinated debt having a very strong month. High yield corporate bonds also performed well.

Key Themes

GLOBAL BONDS
Most non-government sectors still have ample room for improvement

US EQUITIES
Recent strength more typical of a new bull market than a bear market rally

EUROPEAN EQUITIES
Investors encouraged by tentative signs of economic improvement

ASIA-PACIFIC EQUITIES
Capacity to outperform developed markets in the long term

JAPANESE EQUITIES
Companies that have seen sharp inventory depletion present opportunities

EMERGING MARKETS EQUITIES
Continue to outpace developed markets

CHINA EQUITIES
The path to economic recovery is likely to remain volatile

Markets at a glance

	MONTH	YEAR TO DATE	1 YEAR
MSCI WORLD INDEX	9.06%	6.83%	-34.83%
S&P 500 INDEX	5.51%	2.60%	-33.11%
MSCI EUROPE EX-UK INDEX	11.33%	6.83%	-39.72%
FTSE ALL-SHARE INDEX	13.38%	16.81%	-37.71%
MSCI ASIA EX-JAPAN INDEX	16.08%	36.31%	-27.43%
MSCI JAPAN INDEX	10.30%	0.82%	-29.60%
MSCI EMERGING MARKETS INDEX	17.09%	37.87%	-34.36%
MSCI CHINA INDEX	17.27%	32.00%	-22.59%
BARCLAYS CAPITAL Global Aggregate Index	3.57%	1.10%	2.42%

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

Global Equities

GLOBAL CURRENTS INVESTMENT MANAGEMENT

The manager notes that continued uncertainty is likely to fuel volatility in the equity markets, which could bring significant swings in prices over short time periods. The risk of deflation remains for the time being. However, the manager believes investors cannot overlook the massive global policy stimulus – fiscal and monetary – that has been initiated and is currently providing 'green shoots' across the world. Markets also seem to be more optimistic about the ability of governments to rid bank balance sheets of shaky financial assets. Moreover, the decline in inventories, upswing in consumer sentiment, and a bottoming in autos and housing bodes well for a more positive economic outlook going forward. Overall, the manager continues to believe that the capital markets will normalise and the fundamental relationship between risk and return for financial assets will be re-established.

The manager does not believe that low quality stocks will outperform going forward, and in contrast believes that the rally will broaden out and higher quality stocks, which have lagged, have significant potential to outperform. Looking ahead at the balance of the second quarter and beyond, it believes that the weight of evidence reflects the potential for a classic value-driven recovery. 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. Many of the companies the manager invests in exhibit underlying improvements in efficiency in combination with the potential for top line sales growth, which typically will drive earnings growth over the long term.

Global Fixed Income

WESTERN ASSET MANAGEMENT

The manager notes that stabilising economic activity and improving lending activity are now encouraging one another. However, it considers the current recovery fragile and believes central bankers should remain vigilant of further slippage. Although it continues to see forceful headwinds for consumer spending, the manager is confident that economic activity should continue to stabilise and resume positive growth in the near term, even if at a subdued pace. Indeed, the manager believes that the inventory liquidation cycle, which has been the primary detractor from economic growth, is nearing its completion.

The manager has been pleasantly surprised by the strength of the recovery in non-government bond markets over the past two and a half months. It had expected pricing to converge towards fundamental values at a slower pace and is pleased to see market prices rising towards what it had long felt are more accurate valuations. Despite the recent strong performance, the manager believes most non-government sectors still have ample room for improvement and are likely to outperform government bonds over the remainder of 2009 and possibly beyond. Investors fled for the safety of prime money market funds during the crisis. However, with money market investments now generating meagre returns and risk appetite returning, cash is slowly being redeployed in the credit market, helping to support valuations.

Within the non-government sectors, the manager has cut back its exposure to agency mortgage-backed securities in favour of investment grade corporate bonds. The manager believes that valuations in both investment grade and high yield corporate debt still offer tremendous protection against default risks.

"The market strength is more typical of a new bull market than a bear market rally."

Legg Mason Capital Management

US Equities

LEGG MASON CAPITAL MANAGEMENT

The manager believes that the pieces appear to be falling into place that will lead to a recovering economy and a durable market advance. It is encouraged by the positive action of the stock market itself, since it is one of the most reliable leading indicators of economic activity. It thinks the market strength since early March is more typical of a new bull market than a bear market rally. The manager also takes encouragement from the fact that as the broad market averages made successive new lows in October November 2008 and in March 2009, the number of individual stocks making new lows contracted sharply. This is an important characteristic of market bottoms, as it indicates that more and more individual stocks are resisting further decline.

The manager's optimism is based on a number of factors including the action of the market itself, the improvement in credit markets, the ongoing recapitalisation of the US banking system, the dramatic recovery in emerging market equities, and, finally, the upturn, both here and abroad, in a wide variety of leading indicators which normally presage an upturn in economic activity. Although the economic environment remains challenging, the manager notes that a growing number of signs (so-called "green shoots") are emerging that the economy may be stabilising, setting the stage for a recovery beginning later this year or early next. The Federal Reserve's (Fed) current forecast is that the economy is in the process of bottoming and will turn up later this year. If anything, the manager thinks that it is possible that the economy may snap back much quicker than most now expect, at least initially.

European Equities

BATTERYMARCH FINANCIAL MANAGEMENT

Following clear signs of deterioration in the economic slowdown in the eurozone over the first quarter, the investment manager observes that economic data has improved in recent weeks. Indeed, it notes that investors shifted their focus following positive comments from the US Fed on the outlook for the US economy – which gave European stocks their best ever monthly advance in April – and the European Union's sentiment index that jumped significantly for the first time in nearly two years. The European Central Bank reduced its key policy rate by 25 basis points to 1.0% in early May. It also announced a plan to purchase €60 billion of covered bonds in order to provide cash to the financial system (quantitative easing). The manager remains cautiously optimistic on the outlook for European equities, and believes that value can still be found selectively in the region.

Asia-Pacific Equities

BATTERYMARCH FINANCIAL MANAGEMENT

The investment manager continues to believe that Asian economies are generally in stronger positions to weather the global downturn than in previous such environments. Governments have reacted to the current market environment with significant policy initiatives intended to spur future growth, including interest rate cuts and stimulus packages.

Looking ahead, the manager continues to believe that the backdrop of attractively valued currencies, strong foreign reserve positions, and strong domestic consumption in the region, provide a supportive environment for corporate earnings. The manager points out that the combination of compelling valuations, superior growth prospects and solid balance sheets, both at the sovereign and the company level, lead it to remain confident in the capacity of emerging markets to outperform in the long term.

Japan Equities

CONGRUIX INVESTMENT MANAGEMENT[1]

The Bank of Japan (BoJ) left its key policy rate steady at 0.1% during May. Both the BoJ and government officials upgraded their economic projections but pointed out that worsening unemployment and weak consumer spending could trip up a recovery. There were further signs of improvement in economic data, in particular in the manufacturing sector. The government also announced additional stimulus measures, including provisions to boost consumer spending, support small businesses and help jobless workers, which are likely to be passed in June.

In the equity market, the stronger yen led to some market rotation out of exporters into domestic stocks early in the month. The manager has turned incrementally more positive on domestic stocks as it looks ahead to the second half of the year. 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).

"Emerging markets are expected to provide much of the global growth for 2009."

Batterymarch Financial Management

Emerging Markets Equities

BATTERYMARCH FINANCIAL MANAGEMENT

Emerging markets have outpaced developed markets over the year to date. Investors, recognising that emerging market fundamentals have remained strong throughout the global economic turmoil, have been jumping on the rally, reversing the sharp outflows of last year. Indeed, emerging markets, especially China, India and Brazil, are expected to provide much of the global growth for 2009. The International Monetary Fund estimated in January that emerging economies would expand by more than 3% this year as opposed to a 2% contraction for developed countries.

The manager believes that emerging markets have continued to offer a compelling combination of growth, value and attractive fundamentals throughout the course of the downturn, including higher expected earnings growth and greater profitability than developed markets. The back-drop of attractively valued currencies, strong foreign reserve positions, and strong domestic consumption in many emerging market countries provides a supportive environment for corporate earnings. Indeed, it believes that market corrections offer investors a second chance to seek exposure to emerging markets, allowing them to purchase stocks at bargain prices.

China Equities

LEGG MASON HONG KONG ASSET MANAGEMENT[2]

Since the markets reached theirs lows in the middle of March, combination of favourable external and domestic policy events continue to lend support to their re-ratings. Well-received outcome from the stress-testing of major US financial institutions, better than expected macro and micro economic performance from China and further cut in local deposit rates are amongst the recent events which have helped to reinforce investment confidence and elevate risk appetite.

In the absence of any foreseeable unfavourable systematic shock and under current trajectory, corporate top line performance should continue to recover. Further stabilisation in margins and improvement from volume leverage from factors such as customer restocking and lower product pricing will help to support current valuations.

The increase activities in the equity capital markets highlights that normality to asset price discovery is returning. Corporate is becoming more at ease in taking this opportunity from the expansion of their valuations to raise cost-effective equity capital aiming to fund their potential capital expenditure needs. As such, further meaningful increase in corporate investment should help to stabilise employment and consumer confidence.

While we welcome these much appreciated market optimisms and improvement, we are also cautious on the potential of periodic relapses into less favourable outlook with the releases of weaker than expected data points. The path to economic recovery is likely to remain volatile.

[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).