LEGG MASON
GLOBAL ASSET MANAGEMENT

HORIZONS
Monthly Outlook

July 2009

Market Review:
Modest Setback for Equities, Strength in Credit

After rallying significantly from early March, global equities experienced a modest setback during June. Although most markets recovered again by monthend, returns over June as a whole were mixed. While the US and Japanese equity markets gained, emerging markets and Europe lost ground over the month. There were no clear signs as to whether the rally in equity markets would resume or whether the market would move in a different direction in the next few weeks. In April and May, outperforming stocks had tended to be of low quality, however, in June investors rotated away from the riskier, low quality stocks into more defensive assets of higher quality. Economic data in the developed countries generally continued to indicate that economic conditions seemed to be weakening at a slower pace than before, although messages from economists on the outlook for the global economy were mixed. While the World Bank downgraded its outlook, the International Monetary Fund said that the worst may be behind us. Oil prices continued to rise over the month, reaching an eightmonth high.

The recovery in the riskier sectors of the global bond market continued in June, although some of the momentum behind the rally that began in early March faded towards the end of the month. High yield and investment grade corporate debt performed particularly well. However, investors questioned whether pricing in the bond market had outpaced improvements in fundamentals and began to reconsider the possibility of unforeseen setbacks. Financial markets continued to thaw, but clearly remained reliant on support from policy makers. The non-government sectors of the bond market had an exceptional quarter to the end of June. However, credit spreads remain significantly higher than precrisis levels, reflecting concerns over the economic environment as well as the reduced availability of credit.

Key Themes

GLOBAL BONDS
Valuations in the corporate sector remain compelling

US EQUITIES
Weight of evidence suggests new bull market began in March

EUROPEAN EQUITIES
Value can still be found selectively in the region

ASIA-PACIFIC EQUITIES
Offer better expected earnings growth than developed markets

JAPANESE EQUITIES
Earnings upgrades likely in the second half of the year

EMERGING MARKETS EQUITIES
Market corrections offer investors a second chance to seek exposure

CHINA EQUITIES
Upgrade in earnings will be one of the key necessary elements for further market performances

Markets at a glance

	MONTH	YEAR TO DATE	1 YEAR
MSCI WORLD INDEX	-0.45%	6.35%	-29.50%
S&P 500 INDEX	0.14%	2.75%	-26.81%
MSCI EUROPE EX-UK INDEX	-2.28%	4.39%	-34.69%
FTSE ALL-SHARE INDEX	-1.15%	15.47%	-34.21%
MSCI ASIA EX-JAPAN INDEX	-0.47%	35.67%	-18.02%
MSCI JAPAN INDEX	1.76%	2.59%	-23.12%
MSCI EMERGING MARKETS INDEX	-1.35%	36.01%	-28.07%
MSCI CHINA INDEX	4.08%	37.39%	-8.30%
BARCLAYS CAPITAL Global Aggregate Index	0.41%	1.52%	2.76%

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

Global Equities

GLOBAL CURRENTS INVESTMENT MANAGEMENT

The manager's outlook is optimistic for the balance of 2009, given the tangible signs of a slow recovery fuelled by government stimulus and by companies initiating replenishment of inventories. However, it believes markets are likely to be rangebound over the foreseeable future. Valuations have risen since the March lows. However, the manager is still identifying many companies that look attractive to purchase. But the manager notes that the earnings outlook for many companies is murky given that earnings revisions are negative and the rate of down-grading is worsening, and therefore remains focused on highquality companies.

The rally in early 2009 bodes well for hopes that the global recession will draw to an end some time later this year. Of course, to participate in potential upside, investors need to deploy assets and be invested as markets advance. Looking ahead to the second half of 2009, the manager believes that the weight of the evidence reflects significant potential for the highquality value stocks that it purchases for the long term. It strongly believes that sustainable price appreciation will result from investing in stocks with high quality business models and stable cash flows that can generate a total return comprised of price appreciation, share repurchases, dividends and dividend growth. The month of June provided some indication that the market would value higher quality companies more favourably versus the lower quality companies that had performed well during the recent rally.

Global Fixed Income

WESTERN ASSET MANAGEMENT

The debate in bond markets has rapidly switched from concern over a potential deflationary economic scenario to how quickly the global economy may rebound and whether or not inflation is a nearterm threat. While the manager considered talk of prolonged deflation an over-reaction at the time, it also considers this abrupt reversal in sentiment extreme and continues to believe that the road to recovery will be long and bumpy.

Despite viewing the strength of the economic recovery with caution, the manager believes that valuations in the corporate sector of the bond market remain compelling. Indeed, despite the significant rally in recent months, it believes many of the nongovernment sectors have further to go as cash continues to return to riskier assets after sitting on the sidelines during the credit crisis. It notes that financial markets reached a state of total paralysis in late 2008, whereby bond markets failed to perform their fundamental function: to price the variety of risks to which individual bond issuers are subject. However, the bond market has begun to function again and is starting to differentiate between individual bond issuers. The manager expects the credit sectors to strengthen as market conditions continue to normalise and spreads narrow from elevated levels.

In terms of portfolio management, it expects sector and issue selection to gain in importance over the next few months, regardless of how strong the rebound in the underlying economy may or may not be. It continues to hold a preference for investment grade corporate debt, with an emphasis on financials and noncyclical industries, and sees value in holding opportunistic positions in high yield corporate bonds.

"The impetus for rising stock prices will be a recovery in corporate profits."

Legg Mason Capital Management

US Equities

LEGG MASON CAPITAL MANAGEMENT

Two related market controversies continued to rage in June. First, is the market's advance since early March the beginning of a new bull market or merely a bear market rally? And second, if it is a new bull market, is it a cyclical or secular bull? The manager believes the weight of the evidence suggests that a new bull market began in March 2009. Indeed, the investment manager continues to be quite optimistic about the outlook for the US equity market over the next year or two. It believes the cyclical bull market could carry the S&P 500 to between 1,250 and 1,350 by the end of 2010 or the first half of 2011. It thinks the impetus for rising stock prices will be a recovery in corporate profits as the US economy emerges from its sharpest downturn in several decades.

Unlike many other observers, who appear to expect a sluggish recovery, it thinks the severity of the previous downturn argues for a fairly sharp snapback in GDP initially, with growth levelling out at a moderate, but still attractive, rate after that. As the economy begins to improve, it believes the massive amounts of cash on the sidelines (variously estimated at between US$4 and US$8 trillion), earning next to nothing, could power a surprisingly strong advance in the market. True, corrections will occur and many observers believe one is overdue. In the manager's view, however, the combination of improving fundamentals and the massive cash amounts on the sidelines, should limit corrections to 10% to 15%, and it would be surprised to see the S&P 500 break 800 on the downside.

European Equities

BATTERYMARCH FINANCIAL MANAGEMENT

The investment manager notes that economic data continued to improve in recent weeks and both the European Central Bank and the European Commission said that the economy is on track to start growing in 2010. The European Central Bank left its key policy rate unchanged at 1.0% in June, but conducted a massive injection of liquidity into financial markets. Eurozone inflation was negative for the first time ever, but economists agreed that this is unlikely to be the start of a deflationary trend. 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. Indeed, the manager believes that Asian markets still offer better expected earnings growth and profitability than the developed markets.

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]

Overall, the manager remains upbeat on the Japanese market. It notes with interest the increased participation of retail investors, even as institutional investors remain apathetic on Japan.

According to Tokyo Stock Exchange statistics, the proportion of shares held by foreign investors fell to the lowest reading since 2003 at the end of March 2009, although levels have picked up since then. In contrast, individual ownership reached 20% for the first time in four years. The manager would not be surprised to see significant flows into the market, on the back of earnings upgrades in the second half of the year. Recent company meetings held by the manager suggest that earnings estimates are highly conservative, with many companies simply annualising sales trends in the first quarter, at a time when business conditions were probably near rock bottom.

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. Other themes include favouring companies that would benefit from an increase in demand on the back of fiscal stimulus measures implemented by the government. It also favours select commodities, in particular trading companies that are geared towards coal, and environmental names.

Emerging Markets Equities

BATTERYMARCH FINANCIAL MANAGEMENT

Emerging markets have significantly outperformed

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

"Emerging markets offer a compelling combination of growth, value and attractive fundamentals."

Batterymarch Financial Management

developed markets year to date. 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 backdrop 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.

Investors have recognised that emerging market fundamentals remained strong throughout the global economic turmoil. Indeed, emerging markets, especially China, India and Brazil, are expected to provide much of the global growth for 2009. At the same time, however, the manager notes that emerging markets remain undercapitalised. Indeed, while emerging economies represent more than 80% of the world population and land mass, nearly 70% of foreign reserves and more than 50% of GDP (measures at purchasing power parity), the region only accounts for 10% of market capitalisation. Over the long term, it believes emerging capital markets should continue to grow to reflect this superior growth potential.

China Equities

LEGG MASON HONG KONG ASSET MANAGEMENT[2]

While markets continued to deliver positive returns since their turnaround staged in March, the magnitude of returns are more modest in June compared to their stellar performance seen in April and May. As the potential impact of recent stimulus packages is systematically priced into current valuations, fresh impactful catalysts have yet to be announced to further support market rallies.

Improvement in macro and micro economic performances has provided some fundamental support to recent earnings upgrades. The strength of unit sales growth in the private sector has consistently surprised consensus estimates. Loan growth and industry production have also been stronger-than-expected. The front-end loaded China fiscal stimulus packages are showing their intended impacts.

Given the current success in China's fiscal stimulus package, we remain optimistic this will continue to filter through into both the economy and corporate sector in the second half of 2009. With exports remaining weak, policy makers would continue to encourage domestic consumption to partially alleviate the fall in exports. While we are cognizant that global growth and demand may deteriorate further, positive factors such as accommodative domestic monetary conditions, well capitalized financial systems and pragmatic approach to policy options should help Hong Kong and China to weather unforeseen external deterioration.

Given the market re-rating over the past three months, upgrade in earnings will increasingly be one of the key necessary elements for further market performances. As corporate balance sheets have strengthened over the past six months, incremental deployment of this excess capital should help to lift earnings. As we continue to focus on fundamental stock selection, we remain watchful in a shift for greater risk appetite from the perspective of corporate managers. Management guidance at their interim results announcement starting from July may provide the first insights on how these managers are positioning for growth mode in their budget intentions.

[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).