HORIZONS
Monthly Outlook

August 2009

MARKET REVIEW

KEY THEMES

MARKETS AT A GLANCE

THE VIEW FROM LEGG MASON

Market Review:
Equity bulls return; corporate bonds extend gains

Stock markets rallied in July as investors regained their appetite for risk and put their cash to work following the fall back in share values in June. Indeed, there were significant returns across all major regional and global equity indices, and the rally involved not only large-capitalisation stocks but small- and mid-cap stocks as well. And while all equity markets were in positive territory, Europe, Asia ex-Japan and emerging markets stood out as the only regions to post double-digit returns in US dollar terms over the month. More generally, macroeconomic trends were generally positive and, in combination with improved investor sentiment, helped to drive the rally further, reflecting a growing sense among investors that stabilisation was here to stay and the global economy was poised for recovery.

In fixed income, meanwhile, the riskier sectors of the global bond market extended their gains in July on the back of improvements in both economic conditions and the functioning of the financial system. One crucial sector of the economy that showed encouraging signs of improvement was housing, particularly in the US and the UK. Most non-government bond sectors around the world performed well relative to government issues. Subordinated financial bonds in Europe were once again leading performers, although investment grade and high yield corporate bonds also recorded a strong performance across the major developed markets. Elsewhere, US non-agency mortgage-backed securities and emerging market debt produced significant positive returns.

Key Themes

GLOBAL EQUITIES
Rotation into value stocks set to continue

GLOBAL BONDS
Credit markets show ongoing strength

US EQUITIES
Cyclical bull market set to continue into 2010

EUROPEAN EQUITIES
Cautiously optimistic outlook for equities

ASIA-PACIFIC EQUITIES
Renewed focus on fundamentals and bottom-up selection

JAPANESE EQUITIES
Investors await forthcoming elections

EMERGING MARKETS EQUITIES
Better expected earnings growth than developed markets

CHINA EQUITIES
Corporate earnings may need to consistently and positively surprise the market for further price progression

Markets at a glance

	MONTH	YEAR TO DATE	1 YEAR
MSCI WORLD INDEX	8.47%	15.36%	-21.61%
S&P 500 INDEX	7.52%	10.47%	-20.60%
MSCI EUROPE EX-UK INDEX	11.10%	15.98%	-25.74%
FTSE ALL-SHARE INDEX	9.23%	26.12%	-25.10%
MSCI ASIA EX-JAPAN INDEX	13.02%	53.33%	-6.49%
MSCI JAPAN INDEX	4.28%	6.98%	-17.01%
MSCI EMERGING MARKETS INDEX	11.24%	51.30%	-16.84%
MSCI CHINA INDEX	10.83%	52.27%	-0.65%
BARCLAYS CAPITAL Global Aggregate Index	2.21%	3.77%	4.89%

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

Global Equities

GLOBAL CURRENTS INVESTMENT MANAGEMENT

While the manager is extremely pleased to see sizable patches of sunshine and recurring stability in global equity markets, it observes that the rally since the March low point leaves the market looking a little overbought. In July, it says that it began to see signs that investors were paying greater attention to earnings, fundamental factors, and the quality of a company's franchise. In the manager's opinion, many companies are now moving out of 'survive' mode and into 'thrive' mode. It thinks that as the market recognises these stocks, the focus will be on earnings, fundamentals and sustainable growth – the equity markets' primary drivers.

However, the manager notes that it is assessing a number of factors that give it pause for thought, including rising commodity prices, commercial real estate volatility, and a weakening US dollar. Also, it adds that employment data, capital spending, and global trade were negative to mixed during the month. Despite its concerns, however, the manager believes that it has seen many companies excel at efficiently managing labour and capital – a cost-containment strategy that has helped them weather the recession, although it still leaves concern about where top line growth will come from going forward. Looking ahead to the remainder of 2009, the manager believes that the rotation to high-quality value stocks will continue and notes that it has positioned its portfolios to take advantage of solid opportunities.

Global Fixed Income

WESTERN ASSET MANAGEMENT

Following the impressive rebound in leading economic indicators reported in July, the manager believes that most major economies should resume positive economic growth within the next few quarters, putting an end to the severe recession. The manager believes global monetary policy deserves most of the recognition for the rebound. It thinks the massive provision of liquidity over recent months helped to reduce the cautious behaviour of lenders, borrowers, producers and consumers. Nevertheless, the manager believes that the global economy will struggle to sustain a pace of economic growth that would be considered normal by pre-crisis standards. True, the liquidity provided by central banks through their quantitative easing programmes can restore stability to the financial system in the short term. But credit lending provided by the private sector must ultimately recover for the economy to resume its longer term growth path. Indeed, it will take time for financial markets to normalise.

In terms of the market, bonds have experienced an historic rally since late last year, particularly in investment grade and high yield corporate bonds, and have lost little momentum during the seasonally slow summer months. While the manager recognises that bond market valuations are not nearly as attractive as they were just months ago, it continues to believe that credit markets will continue to strengthen, albeit at a much slower pace. The difference in credit yields over government bonds (spreads) has almost returned to levels recorded before the height of the crisis late last year, but remains above levels reached in past economic and market cycles.

The manager continues to believe that corporate debt provides the most attractive investment opportunity in fixed income markets. In its opinion, valuations continue to imply higher levels of defaults than it believes will materialise. Following the strong broad-based gains in credit markets in recent months, it believes investors are starting to differentiate more between bond issuers and sees investment managers' sub-sector allocation and issue selection gaining in importance.

"Massive amounts of cash on the sidelines, earning next to nothing, could power a surprisingly strong advance in the market."

Legg Mason Capital Management

US Equities

LEGG MASON CAPITAL MANAGEMENT

The manager continues to be quite optimistic about the outlook for the US equity market over the next year or two. It believes a cyclical bull market began in March 2009 that could carry the S&P 500 to between 1,250 and 1,350 by the end of 2010 or the first half of 2011. The manager 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. Corrections will occur and many observers believe one is overdue. In the manager's view, the combination of improving fundamentals and the aforementioned cash on the sidelines, should limit corrections to -10% to -15%, and thus it would be surprised to see the S&P 500 break 800 on the downside.

In the manager's opinion, the market was discounting a fairly high likelihood that we were entering another depression in early March. As that scenario came off the table, and the outlook improved from "dreadful" to merely "less worse," the market rallied sharply. It believes the "less worse" phase of the market's advance has about run its course and further sustained upside progress from here will have to be based upon actual improvement in the economy. Happily, the manager believes that is exactly what will happen in the second half of 2009. Its confidence is based on the fact that a wide variety of leading indicators of economic recovery are now flashing green.

European Equities

BATTERYMARCH FINANCIAL MANAGEMENT

European consumer confidence grew during July, the manager observes, and demand for home mortgages was positive for the first time in over three years, despite mounting unemployment and a second month of price declines. Indeed, the manager notes that June and July have been the only periods of disinflation since the advent of the euro in 1999. Looking ahead, it believes the trend should be short-lived, however, with both the European Central Bank (ECB) and the International Monetary Fund (IMF) forecasting price increases later this year. In the meantime, it adds, the ECB is expected to maintain its loose monetary policy. Against this backdrop, 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

July, reports the manager, brought news that the Chinese economy grew almost 8% year-on-year in the second quarter, primarily from domestic consumption. A renewal of IPO activity during July, following a nine-month moratorium, prompted an overwhelming response from investors, it adds. Despite worries of a market bubble, officials vowed to maintain a relatively lax monetary stance rather than dramatically curtail lending. Elsewhere, the manager observes that demand for IPOs is similarly strong in India, whose stock market performance over the last few months also sparked off fears of a bubble. The Indian government increased its inflation forecast during July, it adds, and said that it may soon tighten its monetary policy.

In common with emerging markets more generally, the manager believes that larger emerging Asian economies have demonstrated that their economies are stronger than the market anticipated. At the same time, macroeconomic drivers and policy announcements are fading into the background as investors refocus on fundamentals and bottom-up stock selection. Against this backdrop, the manager continues to find investment opportunities, although it adds that current volatility increases the importance of careful monitoring of portfolio risk exposure.

Japan Equities

CONGRUIX INVESTMENT MANAGEMENT[1]

The manager observes that after coming close to losing its year-to-date gains early in July, once the earnings season got underway the Japanese stock market recovered to show positive returns for the month. More generally, the manager is closely watching the unfolding Japanese election, which takes place at the end of August, and the likelihood of the Democratic Party of Japan (DPJ) unseating the incumbent Liberal Democratic Party (LDP), which has been in power for the best part of fifty years. According to the manager, the DPJ looks virtually certain to sweep into power a consensus even within diplomatic circles. In its view, while not convinced that its policies will lead to a 1% boost in GDP, the manager thinks the DPJ's aim to increase disposable income ought to have a measurable impact on consumption. That's why, since May, the manager has been increasing its exposure to domestic sectors that are most sensitive to changes in disposable income and consumer sentiment. In this vein it has focused in particular on the specialty retail and real estate sectors.

The other significant difference between the DPJ and the LDP is the former's more aggressive stance on environmental issues. Whereas the LDP aims for a 15% reduction in greenhouse gases from 1990 levels by 2020, the DPJ is shooting for a 25% cut. On top of this, the DPJ harbours hopes to raise "anti-global warming taxation measures", in effect

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

an emission tax. If all of these come true, the manager believes that the broadening of its investments under the environmental theme should benefit its portfolios.

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

Batterymarch Financial Management

Emerging Markets Equities

BATTERYMARCH FINANCIAL MANAGEMENT

In the manager's view, the case for emerging markets remains strong and it notes that a significant amount of investor cash remains on the sidelines. Large emerging markets, it believes, have shown that their economies are stronger than the market anticipated and government policies intended to spur growth have begun to gain traction. The manager thinks that a large portion of global growth will be driven by Asia and other emerging markets. Chinese economic activity will be key to the improving economic environment, it adds.

According to the manager, emerging markets still offer better expected earnings growth than the developed markets as well as better profitability. Earnings estimate revisions have bottomed across emerging markets – in fact, they have turned up in many of the large Asian markets and remain negative only in the most commodity-intensive markets, such as Russia, it observes. The backdrop of attractively valued currencies, strong foreign reserve positions and strong domestic consumption in many countries continues to provide a supportive environment for corporate earnings, says the manager. Looking ahead, the combination of attractive valuations, superior growth prospects and solid balance sheets at the sovereign, corporate and household levels lead it to remain confident in the capacity of emerging markets to outperform in the long term.

China Equities

LEGG MASON HONG KONG ASSET MANAGEMENT[2]

Markets rallied in July, posting their third best returns over the year-to-date. According to the manager, the powerful combination of fiscal stimulus and relaxed monetary policies continues to improve investors' confidence and reflate the asset prices of equities and real estate. These wealth effects are beginning to be reflected in an improvement in consumption such as more robust sales of cars, property and retail goods. Furthermore, risk appetites are increasing. Initial public offerings, for example, are well subscribed with monthly gains ranging from 20% to 60%. Property transactions and prices are also gaining upwards momentum.

In the manager's view, loan growth is a key contributor to this turnaround in performance. However, the sharper than expected loan growth in China over the first half of 2009 is beginning to cause some concern among economists, policy makers and investors. For the first half of 2009, new loan creation totalled approximately RMB 7.4 trillion compared to RMB 4.98 trillion for the whole of 2008. While inflation is expected to remain benign in the medium term, the negative side effects of prolonged loose monetary policy are still fresh in the minds of market participants.

According to the manager, as we enter the interim results reporting period, the performance of companies has generally been in-line or slightly above consensus forecasts. Among other positive factors, a lower than expected level of provisioning has helped to reduce the decline in net income. As a result, earnings forecasts have been consistently revised upwards lending support to current valuations. With corporate balance sheets being strengthened by widespread fund raising activities, any increase in corporate investment may help to extend the current round of earnings revision and pricing expectations. The manager welcomes such a turnaround in corporate performance but remains watchful in terms of its sustainability. While a shift in current Chinese government policy will inevitably lead the current market rally to pause, going forward the manager thinks that corporate earnings may need to consistently and positively surprise the market for further price progression.

[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).