

Positive month for global equities and bonds, Economic improvements boost sentiment



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KEY THEMES

MARKETS AT A GLANCE

THE VIEW FROM LEGG MASON

Market Review

Global equities largely had another positive month in September, capping off the third quarter with strong gains, in which emerging markets and Asia outperformed the major developed markets. Japan, meanwhile, lagged behind, with a decline over the month. Increased signs that the global economy is on the mend, and that the unprecedented policy stimulus is having an impact, boosted investor confidence.

In fixed income, investors' risk appetite continued to improve in September as economic activity stabilised and the recovery process lost little momentum. Global non-government bond (credit) markets remained buoyant with the difference in yield over government bonds (spreads) narrowing across most sectors. High yield corporate bonds, corporate bonds issued by financials and US dollar-denominated emerging market debt outperformed the other sectors.

Please refer to the Important Information on the final page.

Markets at a Glance

	MONTH	YTD	1 YEAR
MSCI WORLD INDEX	3.99%	24.90%	-2.29%
BARCLAYS CAPITAL GLOBAL AGGREGATE INDEX (BOND)	2.14%	7.84%	13.51%
S&P 500 INDEX	3.68%	18.59%	-7.65%
MSCI EUROPE EX-UK INDEX	5.51%	30.53%	2.95%
FTSE ALL SHARE INDEX	2.77%	37.23%	-0.58%
MSCI ASIA EX-JAPAN INDEX	8.84%	61.44%	26.74%
MSCI JAPAN INDEX	-1.72%	9.27%	-0.57%
MSCI EMERGING MARKETS INDEX	9.08%	64.45%	19.07%
MSCI CHINA INDEX	4.63%	48.13%	32.21%

All returns are in US dollar terms as at 30/09/2009. Source: Legg Mason.

GLOBAL EQUITIES

GLOBAL CURRENTS

The investment manager notes that in general as markets are always ahead of fundamentals, stock prices already reflect an economic recovery. It anticipates that following the recovery in low-quality stocks from the March 2009 low to the end of the third quarter, markets will see higher quality stocks offering fundamental value taking over the lead. The underperformance of the highest quality and fundamentally best positioned companies in the world in virtually every sector so far this year has created an historic opportunity for investors looking for undervalued stocks. That said, the manager believes that the market's strong upward trend is over and that markets are likely to make little headway over the foreseeable future, with the exception of some emerging markets that may continue to record strong gains.

Looking at the global economy, the manager believes that the world can no longer rely on the profligate US consumer. Moreover, the recent economic dislocation may shift the long-term focus from West to East, given the relative growth and value opportunities that appear promising in Asia and parts of the developing world. As the third quarter drew to a close, the export-dependent nature of Europe led the US in the pace of recovery, especially in France, Sweden, the Netherlands and Germany. However, Spain, Italy and Ireland lagged as their banking, real estate and financial sectors struggled. The manager

expects that new leadership will emerge from US companies that serve the needs of the emerging world and global consumers. On a sector basis, given the vulnerability of some consumer and financial services stocks, it believes investors are likely to see new leadership in sectors such as industrial, materials and technology..

GLOBAL FIXED INCOME

WESTERN ASSET MANAGEMENT

Investors have shifted their focus from short-term concerns over economic and market developments to assessing long-term trends alongside ongoing short-term vulnerabilities across the global economy. Given the sharp contractions in GDP in the US and Europe over recent quarters, these economies now have the potential to grow above trend for a few quarters as part of a cyclical rebound following what the manager considers excessive corporate cost-cutting measures, particularly in the US. However, the manager warns about expectations for a continuation of robust GDP growth after the next few quarters and believes it is more likely to be subdued for years to come.

The manager sees a number of challenges for investors going forward. Although the manager remains more sanguine than the market on the outlook for inflation, it recognises that uncertainty remains unusually high. While the destruction of productive capacity during the recent financial crisis is

Key Themes

GLOBAL EQUITIES

Higher quality stocks to take over the lead

GLOBAL BONDS

Continued value in many credit sectors

US EQUITIES

Correction likely, but should be contained

EUROPEAN EQUITIES

Market beginning to reward improving fundamentals

ASIAN EQUITIES

China key driver of global growth

JAPANESE EQUITIES

Consumer-related sectors should perform well

EMERGING MARKETS EQUITIES

The long-term case for the asset class remains strong

CHINA EQUITIES

China will continue to rebalance its economy towards domestic consumption

likely to put upward pressure on inflation, as the global economy picks up, weak household spending is likely to have the opposite effect on inflation. A further challenge for global investors is to identify lasting impacts from the financial crisis across regions and markets where central banks are likely to hold rates lower for longer.

Despite the strong gains in non-government bonds year to date, the manager continues to see value in many credit sectors and aims to maintain its overweight to the corporate sector. Indeed, it expects spreads on corporate bonds generally to narrow, although it does believe that issue selection and subsector rotation are becoming increasingly important as investors have started to differentiate more between bond issuers. The manager maintains a focus on corporate bonds issued by financials, but is shifting exposure into more senior bonds. Elsewhere, the manager continues to look for opportunities to reduce select holdings in high yield corporate bonds as market pricing improves.

US EQUITIES

LEGG MASON CAPITAL MANAGEMENT

The manager believes that the S&P 500 Index has the potential to reach the 1250 to 1350 range by the end of 2010. It also continues to believe that an intermediate market correction is increasingly likely. The only question is how severe it will be. It believes that the damage will likely be contained to the -5% to -10% level, implying risk in the S&P 500 down to the 965 to 1015 level. At worst, it thinks the S&P 500 could drop back to the low 900s before stabilising. The manager believes investors should remain constructive through any correction, because the risk/reward ratio becomes increasingly favourable as the market declines.

The manager's optimistic outlook over the next 12 to 18 months is based on the following reasoning: credit markets continue to normalise with credit spreads back to levels seen before the collapse of investment bank Lehman Brothers; every meaningful forward-looking economic indicator is pointing to recovery; the recession appears to be ending or over; real GDP growth should be meaningfully positive (+3% to +4%) in the third quarter; corporate profits are poised to snap back sharply and appear to be continuing to surprise on the upside; inflation remains

well contained; and the US Federal Reserve will likely not begin tightening until the latter half of 2010. In short, all of the pieces necessary for a constructive backdrop for equities are falling into place.

The recent spate of disappointing economic numbers notwithstanding, the manager believes that the weight of the evidence continues to suggest that the economy has begun to recover. Even modest nominal GDP growth of 5% over the next year, a well below-average recovery rate by historic standards, will likely produce corporate profit growth of three to four times that rate because corporate America is so "lean and mean," having cut payrolls, inventories and overhead costs so aggressively. If profits recover sharply, as the manager expects, stock prices will ultimately follow.

EUROPEAN EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

The manager notes that economic weakness is abating and growth expectations are improving in Continental Europe, particularly looking forward to 2010. However, it recognises that economic news is not uniformly positive. Indeed, the banking system has not completely recovered and commercial real estate has continued to weaken. Moreover, the recovery may be anaemic and the market rebound may have been fuelled by factors such as central banks' and governments' massive liquidity injections and stimulus plans, and will dissipate once the stimulus runs out.

The manager notes that equity investors are attempting to reconcile signs of growth and economic improvement with the problems that persist such as unemployment. As economic uncertainty decreases, the higher than usual dispersion in analyst estimates looks poised to decline. These conditions bode well for a more balanced and broadened market going forward. While the market is beginning to reward those stocks with attractive fundamental characteristics, such a movement needs to be sustained for disciplined investors to be rewarded. 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.

"If profits recover sharply, as we expect, stock prices will ultimately follow."

LEGG MASON CAPITAL
MANAGEMENT

ASIA-PACIFIC EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

The combination of attractive 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 Asian markets to perform well in the long term. However, over the shorter term, the manager believes Asian markets appear to be entering an environment where outperformance may shift among sectors, sometimes sharply, with the potential for meaningful corrections within sectors from time to time, but with little damage to the asset class as a whole.

Looking ahead, the manager expects that a large portion of global growth will be driven by Asia and other emerging markets. Chinese economic activity, supported by improvement in the US, will be key to the economic environment. Overall, the manager believes that Asian markets continue to offer better expected earnings growth than most developed markets, as well as solid profitability. In addition, it notes that earnings estimate revisions are rising across Asia and are positive across the region as analysts look through to future recovery. The manager believes that the backdrop of attractively valued currencies, strong foreign reserve positions and strong domestic consumption continues to provide a supportive environment for corporate earnings.

JAPANESE EQUITIES

CONGRUUX INVESTMENT MANAGEMENT¹

The Japanese yen strengthened rapidly and sharply in September. With 3-month Japanese LIBOR rates trading above the US dollar equivalent, the yen is no longer the preferred funding currency for the so-called 'carry trade', whereby investors borrow at low interest rates in Japan and invest the funds raised in higher yielding assets elsewhere. Subsequent public statements reiterating the new government's stance against currency intervention further strengthened the yen. As a result, Japanese cyclical exporters led the decline in the equity market in September.

The manager notes that the 6% differential between the performance of the Japanese TOPIX index and the US S&P 500 in September is uncharacteristic. It believes that some comments made by politicians following

the recent election have needlessly shaken investors' confidence. Although such distractions have historically accentuated market volatility, the manager believes that the basic underpinning of what will spur economic growth remains unchanged. Indeed, the manager thinks the new government'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 retail and real estate sectors.

In terms of currency policy, the manager holds the view that no Japanese government can afford to stand aside as the yen demolishes the competitiveness of its corporate sector. As a result, it believes the current period of yen strength should be treated as an opportune time to look for globally competitive Japanese companies.

EMERGING MARKETS EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

In the manager's view, the long-term case for emerging markets remains strong. Large emerging markets, it believes, have shown that their economies are stronger than the market anticipated and government policy initiatives intended to spur future growth have gained traction. The manager thinks that a large portion of global growth will be driven by Asia and other emerging markets. Chinese economic activity, supported by steady improvement in the US, will be key to the improving economic environment. Over the shorter term, the manager believes emerging markets appear to be entering an environment where outperformance may shift among sectors, sometimes sharply, with the potential for meaningful corrections within sectors from time to time, but with little damage to the asset class as a whole.

According to the manager, emerging markets still offer better expected earnings growth than the developed markets as well as better profitability. Earnings estimate revisions are rising across emerging markets. 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.

"The long-term case for emerging markets remains strong."

BATTERYMARCH FINANCIAL
MANAGEMENT

¹ CONGRUUX INVESTMENT MANAGEMENT (a registered business of Legg Mason Asset Management Singapore Pte. Limited).

CHINA EQUITIES

LEGG MASON HONG KONG²

The Hong Kong Hang Seng Index reached its highest level year to date in mid-September, before easing back. It closed the month with a positive gain of approximately 6.8%. The market for mainland domestic A-shares mirrored these developments.

In the absence of fresh fiscal or monetary stimulus packages, investors are likely to focus on negative issues such as the increasing issuance of equity capital, tighter policing on banks regarding their levels of required capital, the granting of mortgage loans to owners of second homes and the potential of an earlier-than-expected “exit-strategy” by China’s policy makers. Given these concerns, markets are likely to consolidate at current levels in the near term.

In the medium term, the direct impact of easily available and attractively priced loans on the prices of real estate should continue to be felt across Asia and in particular in China and Hong Kong. Property developers are taking advantage of this effect by launching new projects and have achieved increasingly higher selling prices. In China, policy makers are aware of the potential risk of inflating prices, but also recognise the positive contribution from property markets in creating steady employment and demand of building materials. Housing demand is likely to be sustainable and increasingly discerning home-buyers will favour developers who offer compelling products and services. Going forward, China will continue to rebalance its economy towards domestic consumption, away from its reliance on export-led growth. Further de-regulation and reforms are expected.

¹ 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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