

## Developed equity markets advance, while emerging markets underperform, **broad-based bond gains**



### ALSO INSIDE

KEY THEMES

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MARKETS AT A GLANCE

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THE VIEW FROM LEGG MASON

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### Market Review

Equities advanced further in the major developed markets during August, while returns in emerging markets, Asia in particular, were mixed after the strong performance of recent months. The major developed equity markets were supported by the consensus view across strategists and economists that the global recession is drawing to an end and a recovery is in the making. Meanwhile, Asia underperformed other developed and emerging regions over the month, led by market declines in China and Hong Kong. The correction in Chinese equities was driven by fears of a cut in bank lending.

In fixed income, continued improvements in economic conditions supported the riskier sectors of the global bond market. Investment grade and high yield corporate bonds generated positive returns in most major regions, although smaller than in recent months. Subordinated financial issues recorded another strong month of performance. At the same time, most government bond markets gained, as investors became less concerned about inflation.

## Markets at a Glance

	MONTH	YEAR-TO-DATE	1 YEAR
<b>MSCI WORLD INDEX</b>	4.13%	20.12%	-17.21%
<b>BARCLAYS CAPITAL GLOBAL AGGREGATE INDEX (BONDS)</b>	1.76%	5.59%	8.52%
<b>S&amp;P 500 INDEX</b>	3.53%	14.38%	-18.92%
<b>MSCI EUROPE EX-UK INDEX</b>	6.67%	23.72%	-17.25%
<b>FTSE ALL SHARE INDEX</b>	5.88%	33.54%	-17.98%
<b>MSCI ASIA EX-JAPAN INDEX</b>	-3.26%	48.32%	-2.83%
<b>MSCI JAPAN INDEX</b>	3.94%	11.19%	-10.17%
<b>MSCI EMERGING MARKETS INDEX</b>	-0.36%	50.76%	-9.95%

All returns are in US dollar terms as at 31/08/2009. Source: Legg Mason.

## GLOBAL EQUITIES

### GLOBAL CURRENTS

In August, the manager notes, the main winners in developed equity markets were generally low-quality companies that had suffered the most in 2008. In many cases, companies with no shareholder value – literally bankrupt institutions that have been saved by governments and taxpayers – outperformed during the month. The manager believes that this type of market behaviour is not sustainable and that investors will see a rotation towards higher quality companies exhibiting lower risk in the remainder of the year.

In terms of the economic backdrop, the manager believes that the worst of the slowdown is behind us and that the recovery is real. However, sustainable growth requires structural change in drivers of growth – and it feels that much of the growth will be coming from Asia. China will play a big role and is likely to be the key driver of global growth going forward. In Asia, revaluation of currencies and, in some cases, vulnerability of export-led growth, will be key factors.

The manager believes that it is likely that global equities are in a temporary bull phase, and that valuations and expectations are critical. Accordingly, it is focused on earnings, fundamentals and sustainable growth – the equity markets' primary drivers. Many of the companies it evaluates are exhibiting record free cash flow, have shown that they can quickly react and protect margins, and are sitting on significant cash that can be deployed to pursue growth opportunities.

## GLOBAL FIXED INCOME

### WESTERN ASSET MANAGEMENT

The manager's investment thesis since early last year has been underpinned by the belief that the provision of liquidity by major central banks would be sufficient to break the cycle between the lack of available credit for the private sector and deteriorating economic conditions. As markets had priced in a much more pessimistic scenario, the manager held a large overweight to non-government bonds sectors, especially in investment grade financial issues and high yield corporate bonds, in anticipation of an improvement in market pricing. The strategy has been successful since November 2008, when credit markets started to show the first signs of improvement.

Despite seeing reasonable potential for a few quarters of above-trend economic growth, the manager believes that the next phase of the business cycle will be characterised by below-trend growth and subtle disinflationary pressures. The manager is more concerned about the possibility of premature rises in interest rates than about the timing of central banks' exit strategies from quantitative easing.

Credit (non-government bond) markets have rallied sharply year-to-date and the manager believes that much of the expected recovery in credit markets has already occurred. However, despite the significant improvement in valuations, the difference in credit yields over government bonds (spreads) remains above levels reached in past economic and market cycles. Although the global economy has

## Key Themes

### GLOBAL EQUITIES

China is likely to be the key driver of global growth going forward

### GLOBAL BONDS

Credit markets should continue to strengthen

### US EQUITIES

Outlook depends on recovery in economic activity and corporate profits

### EUROPEAN EQUITIES

Cautiously optimistic outlook for equities

### ASIA-PACIFIC EQUITIES

The long-term case for the asset class remains strong

### JAPANESE EQUITIES

Significant scope for upward earnings revisions

### EMERGING MARKETS EQUITIES

Offer better expected earnings growth than developed markets

endured the most severe contraction since the Great Depression, credit fundamentals are in better condition than in previous, milder recessions. Indeed, the manager believes that credit markets will continue to strengthen, albeit at a much slower pace, as cash that has been sitting on the sidelines during the crisis returns to financial markets.

The manager aims to maintain its overweight to the corporate sector, but is selectively improving the ratings profile within its allocation to the financial sector. In its opinion, valuations continue to imply higher levels of default than it believes will materialise. Investors are starting to differentiate more between bond issuers and sees investment managers' sub-sector allocation and issue selection gaining in importance.

## 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 1250 and 1350 by the end of 2010. The manager calls this a cyclical, rather than secular, bull market because it thinks it is unlikely, as it sees things now, that the popular market averages will reach new all-time highs before the next bear market sets in. The manager could be wrong, of course, but that is its current thinking. It also believes that the market is vulnerable to a -10% to -15% correction in the near term.

At the March 2009 lows, investors' expectations were so low and their collective outlook so pessimistic that all that needed to happen for stocks to be a good buy was that the world not come to an end. Following the strongest six-month rally in over 75 years, the outlook for stocks from here forward is much more heavily dependent, in the manager's view, upon the strength of the recovery in economic activity and corporate profits. It sees a reasonable case for optimism on both scores, at least relative to muted consensus expectations.

In terms of economic activity, it thinks there is a strong case to be made that the recession is over and that the economy has begun to recover. The latest piece of evidence in support of that view is the Institute of Supply Management's (ISM) manufacturing index,

which rose to a reading above 50, indicating that the manufacturing sector is expanding. Regarding the outlook for corporate profits, it believes that the corporate sector is poised for a sharp recovery. Corporate balance sheets are in generally good shape and free cash flow margins for the sector as a whole have held up surprisingly well due to aggressive cost-cutting in the face of declining revenues.

## EUROPEAN EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

Data released during August showed that the French and German economies have begun to emerge from recession, lifting the eurozone economy as a whole. Inflation for the region declined less than anticipated for August, easing deflationary concerns, and consumer sentiment improved for the fifth month in a row. Unemployment rates in the region remained troubling, however, especially in Spain, where reports indicated an 18% jobless rate for July. The European Central Bank is expected to upgrade its growth estimates for the rest of 2009, despite concerns over unemployment levels and commodity-price volatility, as well as for next year. 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.

## UK EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

Reports released in August showed that the second-quarter economic contraction was slightly lower than first thought. However, data also indicated a much greater drop than predicted in business investment spending for the period. One of the bright spots, meanwhile, was a rise in home prices – the first in two years. In addition, consumer confidence remained at its highest level since the spring of 2008. The UK Treasury suggested that a sustainable recovery is due by year end, although some experts believe that the country's output has been permanently damaged. Although the near-term economic outlook will take some time to improve, the investment manager believes that value can still be found in the UK equity market.

“The outlook for stocks from here forward is much more heavily dependent upon the strength of the recovery in economic activity and corporate profits.”

LEGG MASON CAPITAL  
MANAGEMENT

## Markets at a Glance (continued)

### ASIA-PACIFIC EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

Following months of strong performance, Asia underperformed other regions over August, led down by China and Hong Kong. The manager believes that Asian markets are likely to remain volatile in the near term as long as severe uncertainty continues in global markets, although the long-term case for the asset class remains strong. Indeed, the combination of attractive valuations, superior growth prospects and solid balance sheets at the sovereign, corporate and household level, leads it to remain confident in the capacity of Asian markets to perform well in the long term.

The manager believes 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 both across Asia and, increasingly, across the other emerging market regions. In common with emerging markets more generally, the manager believes that larger emerging Asian economies have shown that their economies are stronger than the market anticipated and government policy initiatives intended to spur future growth have begun to have an impact. At the same time, macro-economic drivers and policy announcements are moving to 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.

### JAPANESE EQUITIES

CONGRUIX INVESTMENT MANAGEMENT

Political events took centre stage in August, as Japan's Liberal Democratic Party (LDP) was unseated by the Democratic Party of Japan (DPJ), after more than 50 years in power. In the manager's view, while not convinced that the DPJ's policies will lead to a 1% boost in GDP, as the party has suggested, 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 retail and real estate sectors.

More generally, the manager continues to expect significant scope for upward earnings revision by corporate Japan. Indeed, the first quarter results validated its convictions. Non-financial firms included in the TSE First Section (TOPIX) Index posted roughly ¥2 trillion in recurring profits in the April-June quarter, a sharp reversal from the ¥3 trillion loss registered in the previous quarter. Even though the return to profit was much earlier than expected, about 88% of companies opted to keep their earnings guidance for the full year intact. With breakeven points significantly reduced compared to a year ago, the manager expects the stabilisation of revenues and improvement in margins to drive a virtuous earnings upgrade cycle.

### 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 are gaining 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.

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 turned up in most 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. Looking ahead, the combination of attractive valuations, superior growth prospects and solid balance sheets at the sovereign, corporate and household level, leads it to remain confident in the capacity of emerging markets to outperform in the long term.

"A large portion of global growth will be driven by Asia and other emerging markets."

BATTERYMARCH FINANCIAL  
MANAGEMENT

## CHINA EQUITIES

### LEGG MASON HONG KONG

The Mainland A-share market corrected more sharply than Hong Kong listed shares during August, highlighting the risk of becoming too optimistic about the pace of the recovery. A-share markets fell approximately 20% from their peak earlier in the year, while the Hong Kong Hang Seng Index has only corrected approximately 6% from its high this year.

As economic performance continues to exceed expectations, earnings expectations and the economic outlook have frequently been upgraded. Interim results announced by corporates have largely been better than expected, as the magnitude of the decline was less than expected. Even China's official Purchasing Managers Index (PMI) picked up to 54.0% in August (a sixteen month high), compared with 53.3% in July.

However, the negative effect from the strong credit expansion in the first half of 2009 is increasingly a focus of concern for policy

makers in China. As a result, a number of micro measures have been introduced aiming to rein in any undesirable expansion of capacity and irregular lending practices. While all these micro measures are positive in building a solid foundation for an economic recovery, the momentum of the recovery and credit availability may level off in the near term. Significant equity capital issuance will further absorb liquidity from the market and concerns over a premature increase in policy rates may limit further market progression.

Beyond these near-term issues, the manager continues to maintain a favourable view on markets in the medium term. As China's GDP per capita increases, sustainable growth driven by consumer demand should emerge. As such, domestic orientated businesses operating in transparent and favourable regulatory regimes will likely be the consistent outperformers in the medium term.

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September 2009

Ref: 4928