Horizons

# Global equities remain strong; Credit markets suffer on weakness in government bonds

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## Market Review

Global equities finished the year on a positive note by generating solid gains across the major markets in December. Financial markets have staged a sustained recovery since March, following the turmoil in 2008 and early 2009, leaving global equities up around 30% in US dollar terms for 2009 as a whole. Signs of sustained growth in the global economy continued to support market sentiment. While emerging markets, in particular Asia, once again led the returns, Japan continued to lag the other major developed markets.

Government bond markets generally declined over December on the back of continued improvements in economic conditions and prospects of significant increases in bond issuance. Although the riskier sectors of the bond market outperformed government bonds, total returns for the non-government bond sectors were generally negative. High yield corporate bonds were one of the few exceptions, posting further gains over the month.

## Markets at a Glance

| | MONTH | YEAR-TO-DATE | 1 YEAR |
|---|---|---|---|
| MSCI WORLD INDEX | 1.80% | 29.99% | 29.99% |
| BARCLAYS CAPITAL GLOBAL AGGREGATE INDEX (BONDS) | -3.76% | 6.93% | 6.93% |
| S&P 500 INDEX | 1.89% | 25.55% | 25.55% |
| MSCI EUROPE EX-UK INDEX | 0.98% | 32.57% | 32.57% |
| FTSE ALL SHARE INDEX | 2.67% | 46.14% | 46.14% |
| MSCI ASIA EX-JAPAN INDEX | 4.35% | 72.08% | 72.08% |
| MSCI JAPAN INDEX | 0.77% | 6.25% | 6.25% |
| MSCI EMERGING MARKETS INDEX | 3.95% | 78.51% | 78.51% |

All returns are in US dollar terms as at 31/12/2009. Source: Legg Mason.

### GLOBAL EQUITIES

GLOBAL CURRENTS

The manager notes that towards the end of 2009, earnings and cash flows generally came in better than expected with analysts significantly raising their estimates. As a result, margins are expected to be at high levels in 2010 with expectations of record highs by 2011. However, the manager questions the sustainability of these earnings versus what appears to be unrealistic expectations. Indeed, while it accepts that stabilisation and economic recovery are broadly evident, it thinks we shall see range bound markets for the foreseeable future. Massive stimulus efforts by governments have produced an improving economy, but the risk is that growth will not support job creation, consumer debt reduction, or sustainable business expansion.

In this environment, the manager observes that finding stocks that can outperform will be challenging. The manager's view is that there is significant underutilised capacity in the global economy and given the risk of a less than robust recovery, there will not be enough growth to go around for all companies within sectors. The result will be stiff competition in many industries and a likely outperformance of high-quality companies compared to the low-quality companies that performed well in 2009.

### GLOBAL FIXED INCOME

WESTERN ASSET MANAGEMENT

The manager notes that the global economy passed through its worst point last summer and would not be surprised to see a few quarters of above-average growth going forward, particularly in the US. However, it remains suspicious about the durability of any above trend growth past 2010 and believes this is also a primary concern for central banks. Indeed, the manager believes that the current rebound is largely driven by the inventory cycle and it expects this support factor to fade later in 2010. In addition, fiscal stimulus is likely to begin to fade around the same time and growing concerns over government finances should limit the political willingness to pass additional fiscal measures. The manager will closely watch employment conditions for signs of a more sustainable recovery and continues to expect that central banks will maintain accommodative monetary conditions for some time.

In government bond markets, the manager is finding the best opportunities in the US compared to Europe and Japan, where optimism and expected rate hikes have risen past levels it finds most probable. It is most concerned about the situation in the UK, where uncertainty surrounding the upcoming election combined with rising debt levels and a heavy dependence on foreign funding make for an unstable environment.

## Key Themes

**GLOBAL EQUITIES**
High-quality companies likely to out-perform in 2010

**GLOBAL BONDS**
Despite strong gains, still value in non-government bonds

**US EQUITIES**
US GDP growth could be much stronger than generally expected

**EUROPEAN EQUITIES**
Market beginning to reward stocks with attractive fundamentals

**ASIA-PACIFIC EQUITIES**
A large portion of global growth will be driven by Asia

**JAPANESE EQUITIES**
Improving employment situation a significant market driver for 2010

**EMERGING MARKETS EQUITIES**
Attractively valued compared to developed markets

Despite its caution over the strength of the economic rebound, the manager continues to hold a preference for non-government bond markets, in particular corporate bonds. As default rates begin to recede, the riskier bond sectors should continue to perform relatively well, at a minimum outperforming government bonds. Should the economic recovery gain a degree of durability, pricing of risky assets could rise further. The manager feels the best value within the investment grade corporate sector is offered by financials. It also continues to see value in high yield corporate bonds.

## US EQUITIES

LEGG MASON CAPITAL MANAGEMENT

The manager remains bullish on the outlook for US equities in 2010. In the latter months of 2009, the manager began to consider that the S&P 500 Index could trade in the range of 1250 to 1350 by the end of 2010, and believes this remains a reasonable expectation. (At 31/12/09 the Index stood at 1115.10). Looking ahead at the next year or so, the manager believes the outlook for the equity market will be determined primarily by the strength of the economic recovery and the recovery in corporate profits, and secondarily by the outlook for interest rates, inflation and the US dollar. In the manager's view, recent economic releases offer fairly convincing evidence that the recession has ended and the economy has begun to recover. Manufacturing Survey data from the Institute for Supply Management (ISM) is strengthening, for example, while retailer and employment surveys are also showing improvement. Despite the recent rush of improving economic news, most observers still seem to be expecting a tepid recovery, with a current Bloomberg consensus forecast for real GDP growth in 2010 of about 2.7%. The manager believes the recovery will be much stronger than that, with real GDP growth in the range of 4% to 5%, and possibly higher. The manager believes the outlook for corporate earnings is also quite strong. Regarding valuations, its conclusion is that the market has meaningful upside even using the more conservative assumptions within its analysis.

Over the longer term, the manager has a number of concerns. The manager believes that the government's fiscal policies will become more important to investors' valuation considerations beyond 2010. The main issues include the government's tax policies, spending priorities, and ability – or lack thereof – to rein in its huge budget deficit, while at the same time maintaining the credibility and integrity of the dollar. The challenges are great and it is far from clear, at this point, how these fiscal issues will turn out.

## EUROPEAN EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

The manager notes that growth expectations are improving in Continental Europe. It recognises, however, that the banking system has not completely recovered and commercial real estate has remained relatively weak. Moreover, some forecasters believe the recovery may be anaemic and the market rebound since March 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. 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.

## UK EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

The manager notes that the UK equity market is significantly driven by global companies that have been rewarded in the rally since March. However, the manager notes that the UK economy continues to lag other major developed countries in moving out of recession. Economic data towards the end of the year was mixed. As markets look beyond the near-term concerns, analysts' earnings expectations are just beginning to be revised positively for 2010. 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.

"We believe the economic recovery will be much stronger than most observers expect."

LEGG MASON CAPITAL MANAGEMENT

## Markets at a Glance (continued)

### ASIA-PACIFIC EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

The investment manager believes that the investment case for Asian markets remains strong. The manager continues to believe 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 also be key to the improving economic environment. During the second half of 2009, macro economic factors and policy announcements moved to the background as drivers of equity market performance, as investors returned their focus to corporate fundamentals. As macro considerations remain in the background, the manager expects bottom-up stock selection to become more important again.

The manager adds that earnings growth is expected to be robust in Asia in the coming year compared with other markets. 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. Exports to other emerging countries are also becoming a more significant driver of returns, reducing the region's dependence on the relatively weaker developed world.

### JAPANESE EQUITIES

CONGRUIX INVESTMENT MANAGEMENT

The investment manager notes that conditions for further global equity gains remain firmly in place: cheap money, reasonable valuations, plus a global synchronised economic recovery. The manager believes that Japan's outlook is helped by factors such as a new progressive government that is already pushing for a very expansionary budget. It adds that Japanese companies have moved cleverly through the recession and are now leaner and trimmer as further recovery unfolds. In key areas, such as precision engineering and energy efficient devices, the manager believes that Japan will benefit from new demand with its competitiveness intact. Going into 2010, the manager's strategy has a very strong tilt towards a rebound in personal consumption, both overseas and domestically, as it foresees a stabilisation and gradual improvement in the employment situation as one of the most significant market drivers over the next year.

### EMERGING MARKETS EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

During the second half of the year, the Fund's investment manager notes that macro drivers and policy announcements in emerging markets moved to the background as investors refocused on fundamentals. Economic data continues to be very robust, an example being the latest strong export growth data from China. The manager notes that such releases are supportive of continued traction for the global economy. It also notes that there are growing signs of increased risk appetite in emerging markets: valuations are reasonable despite the strongest annual gain in the MSCI Emerging Market Index's history, and fundamentals are strong. In addition, earnings growth is expected to be robust in the coming year compared with developed markets. The manager expects that bottom-up stock selection will be key to achieving higher relative performance as emerging markets continue this return to normality. It cautions, however, that a return to risk aversion or a surge in the US dollar could slow emerging markets growth in the near term.

Regarding earnings, the manager notes that estimate revisions are rising across emerging markets, and are positive across most countries. It believes that the backdrop of attractively valued currencies, strong foreign reserve positions, and increased domestic consumption in many emerging market countries, continues to provide a supportive environment for corporate earnings. In addition, domestic consumption and infrastructure development continue to benefit emerging markets, and exports to other emerging countries are also becoming a more significant driver of returns, reducing dependence on the recession-weakened developed world. Despite their strong performance, the manager believes emerging markets continue to be attractively valued compared to developed markets.

### CHINA EQUITIES

LEGG MASON HONG KONG

Similar to the previous month, market performance in December remained muted. With stellar performances for the full year from the Hong Kong Hang Seng Index and the Hang Seng China Enterprises Index (with returns in excess of over 50% and 60% respectively),

"Despite their strong performance, emerging markets are still attractively valued compared to developed markets."

BATTERYMARCH FINANCIAL MANAGEMENT

investors are wary of unexpected headwinds over 2010. Since the rebound of the equity market from the second quarter of 2009, corporate fund raising activities accelerated throughout 2009, supported by positive factors such as the return of investors' confidence, the compression of risk premiums, the low interest rate environment and abundant liquidity.

Looking ahead, the policy reaction to economic developments will remain a key driver of corporate profitability and market performances. Any sign of a re-emergence of inflation is likely to lead to expectations of increasing interest rates and a stronger currency. With a renewed appreciation of the renminbi, fund inflows should lend support to current valuations. On a relative basis, Western economies should continue to de-leverage, while Asian economies increase leverage. This bodes well for improvements in domestic consumption and further asset price inflation. However, the manager remains vigilant of signs of a scaling back of the economic stimulus.



February 2010