

Another volatile month for financial markets amidst fears of a double-dip recession



Key Themes

GLOBAL EQUITIES - GLOBAL CURRENTS

Earnings growth likely to be challenged if the pace of economic growth moderates over the rest of 2010.

GLOBAL BONDS - WESTERN ASSET MANAGEMENT

A focus on globally diversified banks that are large and benefit from multiple funding sources.

US EQUITIES - LEGG MASON CAPITAL MANAGEMENT

The market currently merits a much higher valuation than it is currently being accorded.

EUROPEAN (INCLUDING UK) EQUITIES - BATTERYMARCH FINANCIAL MANAGEMENT

Investors likely to reward fundamentally sound companies that are better equipped to succeed in a low-growth environment.

ASIA-PACIFIC EQUITIES - BATTERYMARCH FINANCIAL MANAGEMENT

Equity markets should continue to reward the resilience and fundamental strength of the Asia-Pacific region.

JAPANESE EQUITIES - CONGRUUX INVESTMENT MANAGEMENT

Capital expenditure stocks likely to do well as domestic capital investment revives.

EMERGING MARKETS EQUITIES - ESEMPIA EMERGING MARKETS

Despite the deceleration in global growth, emerging market equities should continue to produce positive returns over the next 12-24 months.

CHINA EQUITIES - LEGG MASON HONG KONG

Optimism that China can navigate through its current challenges, although there may be periodic decelerations in growth.

Market Review

The final days of June marked a continuation of the market correction in global equity markets and, with the exception of Asia and China, many stocks declined for the month. Investor sentiment was negative as fear became the dominant emotion in equity markets. Investors' range of concerns included a global economic slowdown, slumping consumer confidence, China's growth prospects, and the solvency of European banks. Any interest in risk assets ceased with many investors moving in the opposite direction to safer investments such as Treasuries. Economic pundits generally believe that the potential for a double-dip recession is unlikely. However, the combination of poor consumer confidence, weak job creation, and fiscal spending hurdles suggest that the global economy could deliver slower growth in the second half of the year.

Although performance varied across bond market sectors around the world, the major developed government bond markets generally performed well as the demand for low risk assets increased, while corporate bond markets were impacted by weakness in the financial and energy sectors. While uncertainty over sovereign risk, financial regulation and the potential removal of stimulus measures by central banks continued to affect investor sentiment over the month, the economic outlook became another source of concern as data started to show signs of a slight moderation in the pace of economic expansion.

Markets at a Glance

	MONTH	YEAR-TO-DATE	1 YEAR
MSCI WORLD INDEX	-3.43%	-9.84%	10.20%
BARCLAYS CAPITAL GLOBAL AGGREGATE INDEX (BONDS)	1.53%	-0.31%	5.00%
S&P 500 INDEX	-5.28%	-6.93%	13.73%
MSCI EUROPE EX-UK INDEX	0.01%	-17.82%	4.36%
FTSE ALL SHARE INDEX	-1.37%	-12.75%	10.63%
MSCI ASIA EX-JAPAN INDEX	1.70%	-3.71%	22.13%
MSCI JAPAN INDEX	-2.01%	-2.71%	0.76%
MSCI EMERGING MARKETS INDEX	-0.74%	-6.17%	23.15%
MSCI CHINA INDEX	1.24%	-6.13%	10.89%

All returns are in US dollar terms as at 30/6/2010. Source: Legg Mason.

Market Outlook

GLOBAL EQUITIES

GLOBAL CURRENTS

The manager believes the current slowdown in the global recovery is the result of a material loss of momentum rather than the beginning of a double-dip recession. That said, it observes that the recovery to date has been something of a disappointment – not the instant recovery that was desired – but more a process of arresting the decline of the recession. Moreover, recent disappointments in job growth and income indicators do not bode well for robust economic growth in the near term. Also, the combination of 2011 tax increases and year-over-year declines in stimulus spending will be a drag on economic growth going forward.

For markets, the manager believes that earnings growth will be challenged if the pace of economic growth moderates during the balance of 2010. In short, the premium for growth is expanding in an environment where growth is hard to come by. It continues to anticipate a very competitive business environment in many sectors with not enough growth to go around and the top two or three companies likely to receive all of the orders. Also, the manager expects that the hunt for external growth in combination with strong balance sheets will support future M&A activity. On the positive front, it believes that the austerity measures and financial support taking place in Europe appears constructive – reality is setting in. Also, the recent G20 meeting provided evidence of solidarity in the ‘cut the deficit’ pledge and in the realisation that significant time and resources will be required to address global economic hurdles.

GLOBAL FIXED INCOME

WESTERN ASSET MANAGEMENT

The manager believes that uncertainty will likely persist for some time, driven by a broad array of headlines. Current concerns are focused on whether the US economy will dip back into another recession. The manager believes this is unlikely. Indeed, the economic recovery has largely been driven by businesses rather than consumers and the market seems to be ignoring the strong underlying trends in corporate health in favour of a multitude of other risks. While such risks cannot be ignored, it feels their likely impact on the market will not overwhelm encouraging

fundamentals. The manager notes that a second recession in the US or Europe would additionally require a second shock. While it does not believe this is likely, candidate shocks include a second banking panic and premature fiscal consolidation.

In terms of strategy, the manager continues to favour corporate bonds, but remains selective in terms of sectors and issues. It holds a preference for financials compared to industrials and utilities. Within financials, its focus is on globally diversified banks that are large and benefit from multiple sources of funding and it continues to shift exposure into more senior bonds. Conversely, the manager will continue to avoid small regional banks with concentrated assets and single business lines.

US EQUITIES

LEGG MASON CAPITAL MANAGEMENT

As frustrating as the current environment is, the manager believes that the market merits a much higher valuation level than it is currently being accorded. Unless the economy slips back into recession – a scenario it views as quite unlikely – and corporate earnings turn down, it would expect the market to be meaningfully higher than it is now in the next six months to one year.

If the economy avoids recession and continues to recover, even if haltingly, the manager thinks that earnings should continue to rise. Consensus estimates for the S&P 500 Index for this year and next are currently \$81.73 and \$94.84, according to Standard & Poor’s, putting the S&P at about 12.6x 2010 estimates and 10.9x 2011 consensus based on month-end prices. The equivalent earnings yields are 7.9% and 9.2%, respectively, which are highly attractive in the manager’s view relative to a 3% 10-year Treasury, implying equity risk premiums over the “riskless” asset of 4.9% and 6.2%, respectively. These figures compare to an average equity risk premium of 4.1% since 1926, it adds.

The manager concedes that the dismal performance of equities over the last 10 years has caused investors to lose sight of the long-term appeal of equities. However, it believes stocks are now priced to begin delivering much better returns and that one need not stray far from the beaten path to find good quality mainstream stocks at very attractive prices.

“Stocks are now priced to begin delivering much better returns.”

LEGG MASON CAPITAL MANAGEMENT

Market Outlook (continued)

EUROPEAN EQUITIES (INCLUDING THE UK)

BATTERYMARCH FINANCIAL MANAGEMENT

The manager believes that it is apparent that the recovery will be tempered by the sovereign debt problems in Europe, slow jobs improvement generally and efforts by China to prevent overheating in its own economy. However, it observes that the Chinese government's recent decision to allow its currency to rise against the US dollar is expected to aid equities as increased currency strength in China and the rest of Asia should bolster consumption, and imports, in those markets. With the prospect of slower growth, the manager believes investors will reward fundamentally sound companies that are better equipped to succeed in low-growth environments and it is positioning its portfolio to take advantage of this trend. In detail, it has a slightly cyclical tilt, positioned for global recovery in the next 12 months.

ASIA-PACIFIC EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

As the focus of investors globally has turned to sovereign credit fundamentals, the manager expects equity markets to continue to reward the resilience and fundamental strength of the Asia ex-Japan region. It believes that increased domestic consumption, attractively valued currencies, and strong foreign reserve positions in many of these countries provides a supportive environment for corporate earnings – and a contrast to many developed markets. The manager adds that exports to other emerging countries are now a significant driver of returns, thereby reducing the region's dependence on the developed world.

The manager also believes that the appreciation of China's currency should help the country decrease its focus on exports in favour of domestic consumption, and it expects Chinese imports to increase as other nations become more competitive. It also believes that the rising renminbi should lead to the strengthening of other Asian currencies relative to the US dollar and bolster consumption in those markets as well. The manager feels that such developments should bode well for global equity growth across all markets, particularly Asia.

In the current economic environment, the manager notes that incremental global growth is being led by China. In 2009, for example, China sold more cars than the US for the first time. The manager adds, however, that a recent rise in correlations, continued risk aversion, and macro influences such as European credit-related risks, can be expected to affect equity returns in the short term.

JAPANESE EQUITIES

CONGRUIX INVESTMENT MANAGEMENT

The manager notes that worries over the pace of the global economic recovery and the strengthening yen have subdued sentiment in the Japanese equity market. It also notes that trading volumes have fallen back to their February lows. In terms of its chosen investment themes, the manager tilted its strategy towards capital expenditure-related stocks over the second quarter as it expects domestic capital investment to revive and overseas growth potential to continue developing. Together with its Asian consumption plays, this is where the manager sees the best opportunities and most interesting themes developing in the coming months.

EMERGING MARKETS EQUITIES

ESEMPIA EMERGING MARKETS

Despite the prospect of a deceleration in global growth, the manager continues to expect emerging market equities to deliver positive returns in the next 12-24 months. While earnings expansion should be well supported by strong domestic demand growth across most emerging market regions, the manager also notes that inflation – which is already rising in most countries – is not at levels that would call for drastic action by central banks. In addition, after the recent market volatility, the manager feels that valuations are back at attractive levels, with MSCI Emerging Markets Index trading at 10.4 times forward earnings, a 10% discount against the MSCI World Index and roughly the same as the MSCI EMU Index, which covers the eurozone region. The manager adds that emerging markets offer a more attractive growth profile and stronger macroeconomic fundamentals.

In terms of risks, the manager believes that it is unlikely there will be a repeat of the seizure of the global financial system akin to the one following the collapse of Lehman Brothers in 2008. Its expectation is therefore to see a continuation of the cyclical recovery process in the world economy and not the double-dip recessionary scenario that some observers fear. The manager expects that much like the second quarter of 2010, markets are likely to remain volatile in the coming quarters as Europe's fiscal problems are far from over and negative headlines from the region are likely to limit risk appetite. In this context, it believes that emerging market equities may remain range-bound as the strong fundamentals and attractive valuations of the asset class are countered by negative sentiment towards risky assets in general.

CHINESE EQUITIES

LEGG MASON HONG KONG

As China continues to rein in excess liquidity resulting from 2008's stimulus package and seeks to avoid potential asset bubbles in real estate, the manager observes that emerging issues such as weaker demand from Europe and increasing disputes on labour wages are adding to an already complex set of dynamics.

Over the medium term, it believes that higher domestic income levels should help China to transition from its historic reliance on growth from exports to an increasing reliance on domestic consumption. To enable a smooth transition, it adds, policy makers in China are expected to provide a stable environment for exporters to compete and an attractive social safety net to encourage consumers to spend. A stable and predictable renminbi exchange rate policy and supportive subsidies to encourage exports of higher value-added goods and services are amongst the top initiatives being introduced. As China's GDP per capita rises beyond a certain level, the manager concludes, consumption is expected to accelerate into a higher growth trajectory as happened in the past to other economies.

While in the long term the manager is optimistic that China is capable of navigating through the challenges it currently faces, it thinks markets may have to contend with periodic decelerations in growth as China, along with its trading partners, has to show prudence in the management of its fiscal and monetary policies. Against this backdrop, the manager is currently building up positions in selective companies trading on attractive valuations, which it thinks can take advantage of these transitions.

"China should transition from its historic reliance on growth from exports to an increasing reliance on domestic consumption."

LEGG MASON HONG KONG

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