

Extreme volatility in financial markets as risk aversion returns



Key Themes

GLOBAL EQUITIES - GLOBAL CURRENTS

While stocks are deeply oversold in the short term, the leadership of high return-on-equity (ROE) stocks indicates the earnings environment will become more challenging.

GLOBAL BONDS - WESTERN ASSET MANAGEMENT

Continued focus on corporate bonds, in particular financials, but diversifying strategies that can offset losses from further rises in risk aversion are key in this uncertain environment.

US EQUITIES - LEGG MASON CAPITAL MANAGEMENT

Despite recent volatility, worthwhile gains are likely for the remainder of 2010 and into 2011, as corporate earnings improve and the economy recovers.

EUROPEAN (INCLUDING UK) EQUITIES - BATTERYMARCH FINANCIAL MANAGEMENT

Concerns over the sovereign debt crisis dominate sentiment in Continental Europe. The backdrop for UK equities is somewhat more positive.

ASIA-PACIFIC EQUITIES - BATTERYMARCH FINANCIAL MANAGEMENT

The backdrop of attractively valued currencies, strong foreign reserve positions and increased domestic consumption provides a supportive environment for corporate earnings.

JAPANESE EQUITIES - CONGRUUX INVESTMENT MANAGEMENT

The dislocation in Europe is likely to have a relatively minor impact on the Japanese economy, although the weak euro will be a headwind for Japanese manufacturers who compete with their European peers.

EMERGING MARKETS EQUITIES - ESEMPIA EMERGING MARKETS

Should continue on an upward trend, as valuations remain supportive and earnings growth remains robust, although wide swings in market sentiment are to be expected.

CHINA EQUITIES - LEGG MASON HONG KONG

China's relatively robust fiscal and monetary positions should help to sustain growth and consumption. Given the recent fall in markets, equity valuations are becoming attractive in selective sectors.

Market Review

May was an extremely volatile month for financial markets, as strains in the eurozone, oil spills, geopolitical tensions and looming financial regulation overshadowed generally positive economic data. The sovereign debt crisis in Europe stands out as the major driver of poor financial market performance during the month. As concerns over contagion from the Greek funding crisis spread, eurozone finance ministers announced a major public backstop fund for member countries subject to speculative attacks. However, this only temporarily managed to calm markets.

Risk assets declined across the board as investors' risk appetite fell and demand for traditional safe-haven assets increased. Global equity markets declined sharply, recording the worst one month decline in the history of global equities since the creation of the Morgan Stanley global and international indexes in 1970. US markets plunged in tandem with the rest of the world. In bond markets, the riskier sectors suffered, with corporate bonds issued by financials and high yield corporate bonds declining the most. Government bonds, meanwhile, generally performed well as demand for traditional safe-haven assets increased. Mortgage-backed securities (MBS) issued by US agencies were one of the few non-government sectors to perform well.

Markets at a Glance

	MONTH	YEAR-TO-DATE	1 YEAR
MSCI WORLD INDEX	-9.58%	-6.64%	13.60%
BARCLAYS CAPITAL GLOBAL AGGREGATE INDEX (BONDS)	-1.56%	-1.81%	3.85%
S&P 500 INDEX	-8.05%	-1.74%	20.25%
MSCI EUROPE EX-UK INDEX	-12.81%	-17.83%	1.97%
FTSE ALL SHARE INDEX	-10.98%	-11.46%	10.78%
MSCI ASIA EX-JAPAN INDEX	-8.39%	-5.31%	19.53%
MSCI JAPAN INDEX	-8.09%	-0.72%	4.63%
MSCI EMERGING MARKETS INDEX	-8.80%	-5.47%	22.39%
MSCI CHINA INDEX	-5.46%	-7.28%	14.00%

All returns are in US dollar terms as at 31/5/2010. Source: Legg Mason.

Market Outlook

GLOBAL EQUITIES

GLOBAL CURRENTS

The manager is concerned that measures of sentiment and economic momentum are showing signs of peaking across the world and that there is a distinct loss of momentum; a worrisome observation at this stage of the economic recovery. It also notes that valuations remain relatively high due to very high 2011 earnings expectations. In response, its strategy has been to focus on a mixture of low valuation, quality balance sheet, resilient business models and relatively less cyclical revenue streams. While being mindful that stocks are deeply oversold in the short term, its experience leads it to take note of the message being sent by the markets, namely the leadership of high return-on-equity (ROE) stocks indicates a challenging earnings environment is coming. The manager anticipates that equity markets will continue to be range-bound going forward. Given significant volatility and uncertainty in the marketplace, it has built a balanced strategy that prepares its portfolios for global growth and recovery, but also takes into account the potential for challenges and setbacks. Resilience requires sustainable cash flows and high quality internal growth drivers that provide a competitive edge for companies within an industry.

More generally, the manager believes that the unsustainable imbalances around the globe are finally reacting to the weight of market forces and that an adjustment process is advancing. Accordingly, several positive signs are becoming evident. In many areas of the world, pro-growth policies have emerged and structural changes are being implemented that should be favourable. Commodity prices are falling, curbing inflation fears in many areas of the world. In Europe, governments are being forced to cut costs, institute labour and pension reform, and pursue austerity measures. Overall, the manager believes that the healing process has begun and market forces are improving the structural foundation of the global economy.

GLOBAL FIXED INCOME

WESTERN ASSET MANAGEMENT

The manager believes that the positive cyclical momentum behind the global economic recovery will be sufficient to support price appreciation in corporate bond markets going forward and aims to maintain an overweight

exposure to investment grade and high yield corporate debt. The manager maintains its preference for corporate debt issued by financials compared to industrials and utilities, as valuations remain attractive and the sector continues to benefit from balance sheet repair, improving asset quality and bond-holder friendly managerial strategies. However, it emphasises that issue selection is important. Its positioning reflects a clear focus on large and globally diversified financial institutions and it will look to continue shifting exposure into more senior bonds, as opportunities arise. Similarly, within high yield, the manager is gradually moving its exposure into higher-rated issues.

Despite its generally positive outlook, the manager notes that markets are likely to experience further temporary setbacks and considers market developments such as those seen in May as a buying opportunity for risk assets on a selective basis. The manager anticipates that concerns over the stability of the eurozone and the strains this places on the European banking system will be an ongoing source of uncertainty and therefore gives priority to diversifying strategies that can offset losses from further rises in risk aversion. Holding US duration is a key component of these strategies, given the safe-haven status of the US dollar and the tendency for US Treasuries to benefit from rising uncertainty. A substantial short position to the euro is another component of these strategies, as currency weakness remains the primary valve through which pressure in financial markets can be released.

US EQUITIES

LEGG MASON CAPITAL MANAGEMENT

The manager strongly believes that further material weakness in the equity markets is unlikely, and that the market is, in fact, in the process of stabilising at current levels, and will resume its advance in the next few weeks. It believes gains from the present level could come more haltingly, with volatility likely remaining elevated, though probably not as high as in recent weeks. It continues to see worthwhile gains ahead for the remainder of 2010 and into 2011, with its long-stated year-end 2010 target range of 1250 to 1350 on the S&P 500 Index still seeming like a reasonable objective. Despite the recent unwelcome spike in volatility, one thing which gives the manager considerable confidence

“The manager anticipates that concerns over the stability of the eurozone will be an ongoing source of uncertainty.”

WESTERN ASSET MANAGEMENT

Market Outlook (continued)

that we are not seeing a replay of 2008 in 2010 is the behaviour of credit spreads. Credit spreads have widened a bit, but nothing like they did in 2008. As long as credit spreads remain comparatively well-behaved, the manager thinks there's a very good chance that further damage to the equity markets will be relatively minor.

Although the US equity market faces an unusually large number of uncertainties at present, including the impact of the sovereign debt crisis on Europe and a policy-induced slowdown in China on Asian economies, the manager notes a number of factors that are currently supportive of higher equity prices. Corporate earnings are rising and the economy is recovering, supported by an accommodative Federal Reserve, which is not worried about inflation in the near and intermediate term. Based on these reasons, it believes the US equity market can go up, but the progress from here could be grudging.

EUROPEAN EQUITIES (INCLUDING THE UK)

BATTERYMARCH FINANCIAL MANAGEMENT

With Greece's rescue package in place, the manager believes that Spain and Portugal are now considered the eurozone nations most at risk from the sovereign debt crisis in Europe. The euro continued to decline on the back of investor concerns and the manager notes that many economists believe that it will continue its descent. Meanwhile, the manager notes that the backdrop for UK equities is somewhat more positive. The manager observes that UK economic indicators were mixed over the period. While manufacturing expanded as export orders rose and the employment rate improved, retail sales took an unexpected nosedive. Against this backdrop, the manager currently has an overweight position in the UK and a slightly underweight position in Europe ex-UK in its global portfolios.

ASIA-PACIFIC EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

The manager observes that earnings estimate revisions continue to be positive across Asian countries. The backdrop of attractively valued currencies, strong foreign reserve positions and increased domestic consumption in Asian markets provides a supportive environment for corporate earnings. Domestic consumption

and infrastructure development continue to benefit these markets, while exports to other Asian countries and other emerging markets are also becoming a more significant driver of returns, reducing dependence on the US and western Europe.

The manager expects that bottom-up stock selection will be key as the Asia ex-Japan region continues to demonstrate positive earnings growth, while providing attractive valuations. However, a return to risk aversion, aggressive monetary tightening before the recovery gains momentum or a surge in the US dollar could slow emerging markets growth in the near term.

JAPANESE EQUITIES

CONGRUIX INVESTMENT MANAGEMENT

The manager expects the dislocation in Europe to have a relatively minor impact on the Japanese economy. Europe has long lost its importance as a major trade counterpart for Japan with its export share at about 11%. Nonetheless, the state of affairs may be more challenging for individual Japanese companies. For a start, the weak euro will be a headwind for Japanese manufacturers who compete with their European peers in industries such as automobile and capital goods. Of more significance, is the magnitude of downward earnings revision due to foreign currency translation. The yen has already appreciated by more than 10% compared to the 125 yen/euro cross rate assumed by most Japanese companies. Hence, operating profit targets for this fiscal year may be reduced by as much as 30% for some exporters. However, as we head into June, the manager is turning more constructive on the market. While there are lingering uncertainties regarding the European debt crisis, the weak euro may prove to be a much-needed stimulus for eurozone growth.

EMERGING MARKETS EQUITIES

ESEMPLIA EMERGING MARKETS

The manager notes that emerging economies are once again growing faster than the developed world, and are currently enjoying the strong tailwinds of global restocking and increasing global demand. Emerging markets are also benefiting from healthy domestic demand, leading to strong consumption and investment growth across most developing countries. Given this backdrop, the manager

notes that it is not surprising that inflationary pressures are building up faster in emerging economies compared to developed markets, thus putting pressure on central banks in emerging markets to tighten monetary policy conditions sooner. However, in general, the manager believes that central bankers will tread carefully and tighten slowly because of the uncertainties surrounding the sustainability of the recovery in the developed world.

In terms of market performance, the manager still expects emerging market equities to continue on an upward trend, as valuations remain supportive and earnings growth remains robust. The manager also notes, however, that it expects to see wide swings in market sentiment in coming quarters similar to those experienced year to date. It adds that such volatility is natural given the current environment, as markets are forced to digest considerations such as the ending of ultra-loose monetary policy and quantitative easing, and the prospect of fiscal consolidation and continuing uncertainty over the sustainability of economic recovery in developed countries.

Sharp exchange rate fluctuations along with rising interbank funding costs will present challenges even to seasoned management teams. Beyond current sovereign debt issues in Europe, China along with most Asian countries should be able to weather this period of volatility. China's relatively robust fiscal and monetary positions should help to sustain growth and consumption, despite the outlook for weaker trade with developed nations.

Given the fall in markets and robust earnings expectations thus far, the manager believes that equity valuations are becoming attractive in selective sectors. Valuations in sectors such as property and financials are trading at or lower than their long-term average levels. From a stock level perspective, the manager continues to consolidate into its higher conviction ideas. It believes that any reversal in policy measures will help to lift overall market and stock valuations.

“We expect the dislocation in Europe to have a relatively minor impact on the Japanese economy.”

CONGRUI XI INVESTMENT
MANAGEMENT

CHINESE EQUITIES

LEGG MASON HONG KONG

Mainland Chinese markets registered the second largest month-on-month decline this year. Concerns over the contagion effects from the sovereign debt problem of peripheral European countries on core Europe gathered momentum, adding to local concerns over China's rising inflation and impacts from ongoing measures to cool property price inflation. Any potential economic slowdown in Europe will add to the complexity in anticipating policy responses and estimating economic performance.

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