

Global equity markets fall as fears heighten over Greek debt crisis



Key Themes

GLOBAL EQUITIES - GLOBAL CURRENTS

Many measures of sentiment and economic momentum are showing signs of peaking. Markets likely to remain range-bound over the short to medium term.

GLOBAL BONDS - WESTERN ASSET MANAGEMENT

Continued focus on corporate bonds, in particular financials. In government bonds, the manager remains comfortable holding additional duration, as it believes that rate hikes will not occur as early as the markets expect.

US EQUITIES - CLEARBRIDGE ADVISORS

A preference for companies that pay dividends, invest in research and development, repurchase their own shares when cheap, and make niche acquisitions.

EUROPEAN EQUITIES - BATTERYMARCH FINANCIAL MANAGEMENT

Economic indicators in the UK remain mixed, while Greece downgraded to junk status. Overweight UK; neutral on Europe.

ASIA-PACIFIC EQUITIES - CONGRUUX INVESTMENT MANAGEMENT

The impact of stimulus withdrawals and rate hikes may ultimately prove to be exaggerated. Further improvement in valuations coinciding with rates peaking could prove interesting from an investment perspective.

JAPANESE EQUITIES - CONGRUUX INVESTMENT MANAGEMENT

Market sentiment remains positive, supported by positive US macroeconomic data, which continues to reinforce the prospects of a healthy exports recovery for Japan.

EMERGING MARKETS EQUITIES - BATTERYMARCH FINANCIAL MANAGEMENT

Russia favoured, followed by Egypt, Turkey, Indonesia and Mexico with underweight exposures to Malaysia, Taiwan, Israel, India and South Korea.

CHINA EQUITIES - LEGG MASON HONG KONG

Given recent strong Q1 GDP growth, the macroeconomic outlook remains favourable. Domestic consumption has remained robust and exports continue to rebound as countries replenish their inventories.

Market Review

Global equity markets lagged the US stock market during April as investors were mired in uncertainty, including the events surrounding Greece's debt crisis, financial reform legislation, and China's efforts to manage growth. Indeed, despite almost three out of four global companies beating expected profits and after performing strongly initially, global stocks corrected sharply in the second half of the month. Nevertheless, investors were encouraged by signs of economic vitality such as consumer confidence, productivity gains, employment stabilisation, supportive central banks, and corporate profits recovery. The overall trend suggests that the economy is moving in the right direction, although there is some uncertainty as to how robust the recovery might be as the year progresses.

Bond markets were volatile during April as relatively strong economic data and better-than-expected corporate earnings were partially overshadowed by increasing concerns over sovereign debt and, in particular, the potential contagion effects a Greek default could trigger. While the riskier sectors of global bond markets generally performed well, the eurozone government bond market struggled over the month with investors fleeing towards the relative safety of US Treasuries. Within corporate bond markets, European issues underperformed the US. As fears about Greece continued to rise, the European Commission and the International Monetary Fund stepped in at the end of the month to announce a €110 billion rescue package that would cover the country's borrowing needs for at least two years.

Markets at a Glance

	MONTH	YEAR-TO-DATE	1 YEAR
MSCI WORLD INDEX	0.01%	3.25%	37.02%
BARCLAYS CAPITAL GLOBAL AGGREGATE INDEX (BONDS)	0.02%	-0.26%	9.26%
S&P 500 INDEX	1.55%	6.86%	37.97%
MSCI EUROPE EX-UK INDEX	-3.46%	-5.76%	30.20%
FTSE ALL SHARE INDEX	-0.49%	-0.53%	41.10%
MSCI ASIA EX-JAPAN INDEX	2.06%	3.36%	51.46%
MSCI JAPAN INDEX	-0.16%	8.02%	25.57%
MSCI EMERGING MARKETS INDEX	1.21%	3.65%	57.13%
MSCI CHINA INDEX	-0.36%	-1.93%	41.40%

All returns are in US dollar terms as at 30/04/2010. Source: Legg Mason.

Market Outlook

GLOBAL EQUITIES

GLOBAL CURRENTS

The manager believes that many measures of sentiment and economic momentum are showing signs of peaking. In its view, optimistic analysts' estimates, bullish investor bets, mutual fund cash levels, the relative performance of risky assets and myriad leading indicators all reached elevated levels during April. The most ominous development in the manager's opinion is the situation in China, which was reflected by both leading economic indicators and the stock market heading down. Additionally, India, Brazil and China have begun tightening monetary policy to combat rising inflation and reign in potential speculative asset bubbles. The fiscal deficit crisis in Europe, meanwhile, regained the headlines in April as the impact of Greece's current account deficits for the past decade came to a head.

The manager observes that we are seeing a process whereby governments bail out companies, people and banks that run out of money – which then requires governments to bail out other governments that run out of money. It anticipates an eventual end to what it describes as a dysfunctional era when societies are forced to confront a generation of promises they cannot keep and people realise we can't afford more of what we can't afford. Against this backdrop, the manager anticipates that equity markets will continue to be range-bound going forward.

GLOBAL FIXED INCOME

WESTERN ASSET MANAGEMENT

The manager's conviction that central banks will leave interest rates at low levels for some time has strengthened given the impact of the Greek funding crisis on financial markets. Indeed, it believes that disinflationary pressures are the predominant concern across most major economies, as excess capacity in labour markets should result in subdued wage growth. As concerns over the ability of governments to fund their deficits and meet their debt obligations rise along with public debt levels, the manager believes that the burden on central banks will only increase and that rate hikes are therefore likely a distant event.

In its portfolios, the manager has an emphasis on corporate bonds, in particular financials. Indeed, it believes the sector continues

to offer better value than the utility and industrial sectors. In government bonds, the manager remains comfortable holding additional duration, as it believes that rate hikes in Europe and the US will not occur as early as the markets expect. The manager has chosen to emphasise countries that it believes will have little trouble funding deficits in coming years, preferring the US to the UK because in its view the latter faces greater challenges in terms of debt reduction. The manager also continues to allocate away from the Japanese market, as yields are relatively low compared to other major markets. In European government bonds, the manager prefers longer dated issues, but country risk differentiation is crucial. The manager has an emphasis on the core eurozone countries and maintains a reduced allocation to the periphery within the region. The manager also holds a significant short position in the euro, which should act as a hedge against further turmoil in European bond markets.

US EQUITIES

CLEARBRIDGE ADVISORS

The manager notes that financial markets now face the question of how the US economy and interest rates will fare in the transition from stimulus-inspired demand to private sector-driven growth. From the depths of the recession, it observes, corporate profitability and cash flow have bounced back well. Indeed, it adds that the disasters of 2007-2008 have led many companies to squirrel away cash, leaving balance sheets, overall, in good shape. The manager says that it seems clear that the emergency policy of zero-interest rates has enabled banks to rebound and begin to rebuild their balance sheets and profitability. Unfortunately, it adds, corporate profitability has come primarily from cost-cutting, which has resulted in high unemployment. In its view it is impossible for the economy to cost-cut its way to prosperity and at some point there needs to be renewed revenue growth, significant enough to cause companies to begin hiring.

In an environment of enormously mixed signals, the manager has emphasised the importance of owning high-quality assets. It continues to feel that stocks offer more value than artificially inflated bonds. The manager prefers companies that have the ability to pay dividends, invest in research and development, repurchase their own shares when cheap, and

"The burden on central banks will only increase... rate hikes are therefore likely to be a distant event."

WESTERN ASSET MANAGEMENT

Market Outlook (continued)

make niche acquisitions. Coincidentally, it adds, many of those companies make the products that people need or want all over the world, and many of their stocks remain reasonably valued. This hasn't necessarily been where the highest payoffs have been to date in the recovery, but the manager feels there are enough uncertainties and pitfalls in the economy to make it stay on this investment course.

EUROPEAN EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

The manager observes that UK economic indicators were mixed over the period. While retail sales growth hit its highest level in four years in March, it waned in April as job losses climbed and the inventory of houses on the UK property market grew. Indeed, unemployment increased by 0.1% in April according to the manager and at 8% is the highest rate since September 1996. In continental Europe, meanwhile, Portugal, Greece, Italy, Ireland and Spain were the focus of the world's attention as sovereign debt and, by association, the financial health of the euro and the eurozone came sharply into question. Greece, Portugal and Spain all had their debt downgraded within days of each other, which further heightened fears that Greece's risk of default was not contained. Indeed, S&P's downgrade of Greece's debt to junk status was a first among euro member nations since the launch of the currency in 1999. After struggling to reach an agreement for several months, EU leaders and the IMF finally agreed on a preliminary bail out plan at the end of the month. Against this backdrop, the manager currently has an overweight position in the UK and a neutral position in Europe ex-UK in its global portfolios.

ASIA-PACIFIC EQUITIES

CONGRUIX INVESTMENT MANAGEMENT

Although the performance of Asian stock markets has at best been pedestrian this year, the manager is comfortable with the current state of affairs. It thinks that the fear of the impact of stimulus withdrawals and rate hikes may ultimately prove to be exaggerated. Indeed, it believes that the headwinds of recent months have been more than nullified by the tailwinds of earnings growth and capital flows. In general, observes the manager, growth is surprising but inflation is not. This

is most evident in China and India, and even in Singapore, where the latter announced a whopping 13% growth for the first quarter of 2010. The manager thinks we are edging closer to the point of inflation peak and rate pause, whereupon growth and valuation will take over as the prime drivers for stock market direction.

More generally, the manager observes that government policies have been implemented on an incremental basis, albeit more strongly so than in the past. It thinks the probability of interest rates rising so sharply as to damage affordability is low in the near term. Price appreciation in Asia has been rapid, but the manager does not think this implies an imminent about turn. To conclude, it is watching market developments closely and thinks that further improvement in valuations coinciding with rates peaking could prove interesting from an investment perspective.

JAPANESE EQUITIES

CONGRUIX INVESTMENT MANAGEMENT

The manager observes that the Japanese equity market remains fairly resilient despite expectations of profit taking and renewed concerns over Greece. In fact, market sentiment is positive and this has been supported by positive US macroeconomic data, which continues to reinforce the prospects of a healthy exports recovery for Japan. Given the sharp rebound in corporate profits since the fourth quarter of last year, the manager thinks that capex is likely to show a marked improvement in the coming quarters. Elsewhere, anecdotal evidence continues to support the steady rise in industrial activity.

In terms of company results, the manager observes that the season got off to a good start with few negative surprises as most companies delivered numbers in line with previous forecasts. Interestingly, share prices of a number of stocks with weak guidance closed in positive territory after the initial sell off, which the manager thinks is indicative of the positive sentiment towards the market.

EMERGING MARKETS EQUITIES

BATTERYMARCH FINANCIAL MANAGEMENT

The manager observes that at the end of April, China became the beneficiary of a World Bank agreement intended to provide emerging economies with more influence at the institution. The agreement provides

China with greater voting shares, ranking them behind the US and Japan but ahead of Germany, Britain and France. Elsewhere, the Indian central bank continued to tighten monetary policy and raised short-term interest rates by 25 basis points in April. And Brazil's central bank also raised its core interest rates by a greater than expected 75 basis points to deal with rising inflation and the threat of an overheating economy. Against this backdrop, the manager's biggest overweight in emerging market equities is currently Russia, followed by Egypt, Turkey, Indonesia and Mexico with underweight exposures to Malaysia, Taiwan, Israel, India and South Korea. In terms of sectors, the manager currently favours materials, automobiles & components, capital goods and retailing. Its largest underweights include the energy, utilities and pharmaceutical sectors.

CHINESE EQUITIES

LEGG MASON HONG KONG

The manager observes that while external issues have focused on the weaknesses of selective European nations, such as the sovereign debt issue in Greece, China is pre-occupied with the negative impacts from the strength of its recovery. It thinks that the lack of resolution on Greece's sovereign debt issue and the recent credit downgrade on Spain has reminded investors of the fragile and unbalanced state of recent economic recovery. In China, policy makers are increasing their administrative measures to cushion the impact from rising inflation and excessive

price appreciation in the real estate market. Economic growth has continued to impress investors – first quarter 2010 GDP growth reached 11.9 % and current accounts turned into deficit in March for the first time since April 2004.

Given its recent performance, the manager believes the macroeconomic outlook for China remains favourable. However, in response to the country's targeted tightening measures, valuations on sectors such as banking and property have contracted and continue to price in investors' concerns, it adds. But attractive valuations are emerging in selected mainland banks and the contraction in liquidity conditions has helped to improve banks' pricing power on loans. The manager therefore intends to capitalise on these weaknesses to build on its active positions in this sector. Elsewhere, valuations in the property sector may see further compression as industry participants re-adjust their expectations. In the near term, the manager thinks developers may need to re-position their product offerings to attract homebuyers. Furthermore, buyers will need to work with tighter guidance on mortgage lending.

Beyond these interest rate sensitive sectors, the manager observes that domestic consumption has remained robust and exports continue to rebound as China's export markets replenish their inventory levels. The manager aims to identify attractively valued business leaders that can capture these positive trends.

"Domestic consumption [in China] has remained robust and exports continue to rebound."

LEGG MASON HONG KONG

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