Perspectives

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Investment Perspective
May 14th, 2010

Given recent market and economic developments in Europe, Asia, and the United States, we wanted to provide some observations and our perspective on recent events.

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The political and economic events of the past few weeks have been like viewing a 2 AM infomercial with all the fast talk, changing prices, escalating offers and glossed over statements about shipping and handling charges.

The solution to the Greek crisis started out as one easy payment of 45 billion Euros…but wait, there's more…it's really 110 billion…and for a limited time only if you call in the next 20 minutes it will be 750 billion!

On the next channel someone is selling a magic elixir called "China" that is supposed to cure all ills including excessive leverage, rising input costs, low operating rates, sluggish job growth, and non-existent personal income gains and overspending by bankrupt governments. The problem is that each week the price of this magic bottle is going down not up, a sure sign that something is wrong. Finally, on the SCI-FI channel there was a compelling presentation by 'Rapid-Fire Advisors,' promising profits every nanosecond with their sure-fire computer driven trading strategy.

I know this sounds cynical and a bit harsh but the reality is worse. The delusion and deception that has led to a mind-boggling level of complacency has set up investors to experience these "emperor has no clothes" moments. I don't see any evidence of this changing based upon the recent actions of the ECB in Europe. The growth that everyone is banking on in China shows signs of peaking as the stocks there enter an "official" bear market. Short term, computer model driven noise traders account for 60% to 70% of daily volumes, which has the dual effect of providing a fragile source of liquidity and detaching stock prices from economic reality. In the following comments, I share some interesting thoughts and insights about what is going on right now and what it means for stocks and the global economy. Many of these are the observations of others, which I include given that they are often brilliant, brutally to the point, or so ridiculously foolish that you would not believe I could come up with them on my own.

- Greece has run a current account deficit of 8% to 10% of GDP for the past decade and highlights the Fairy Tale scheme many countries created out of the EMU. Bloomberg news columnist Caroline Baum noted that Greece has spent half the years since its independence in 1829 in default - a fact which she credits to economists Carmen Reinhart and Ken Rogoff in the book "This Time is

Different."

- The underlying flaw in the EMU is that the decision makers have put economic union before political union. There are not adequate cross-border institutions to prevent or deal with the massive imbalances that currently threaten the Euro. Caroline Baum bluntly stated "Political union is still a dream. Germans are still Germans, and Greeks are still Greeks. The man on the street in Dusseldorf probably doesn't understand why the German Government has to fork over what could be his pension to a country for whom default is a way of life."

- The basics of the EC's plan are a three-part 750 billion euro stabilization package. 1) A balance of payments facility of 110 billion Euros; 2) A 440 billion Euro SPV (special purpose vehicle) to buy sovereign debt no one else wants and to back the liabilities by the ECB; 3) An IMF 250 billion Euro tranche to provide liquidity to EU countries unable to roll their debt in the private markets. The US Fed is also providing loans (history shows calling them short term is not accurate) via forex swaps. Joan McCullough, a market strategist at East Shore Partners notes that "This means that Germany is pretty much guaranteeing that they are gonna be left holding the bag for everybody else…the paper they will be buying back will be paid for by printing money, something which the ECB denied right up to the last moment. At the end of the day…the FED is printing money to lend to an insane group of politicians…who are willing to print almost a trillion units of their own currency…and in so doing are placing an unknown, limitless burden on the US taxpayer."

- A lot of details remain obscured with seemingly conflicting statements coming out of Euro zone central bankers and politicians. How the SPV and the ECB purchase the troubled country bonds is critical to reducing spreads. The ECB states it will not print money, but act to sterilize bond purchases, which would keep interest rate costs high for Greece, Spain, Italy, Ireland and Portugal. In classic Orwellian-speak, German Chancellor Angela Merkel said recently that the bailout package had become necessary because there was a "broad assault on the euro…and we are protecting the money of the people of Germany. The Euro zone member states showed that we have a common political will to do everything for the stability of our common currency." The people who built the system that has failed and is collapsing are proposing that more debt, deception and money printing will "protect" the Euro. Read on when you stop laughing (or crying).

- On a positive note, the German people, upon hearing the good news from Frau Merkel, promptly diminished her power by taking away her party's majority in the Bundesrat. Also, a group of German academics are challenging the legality of imposing the euro on the German people in the first place. Given that virtually every assurance, promise and agreement made to the German people has been violated or abandoned, I would not underestimate this threat to the EU stability pact.

- UBS Senior Economist George Magnus succinctly states: "There is no plan for debt restructuring, no mechanism to enforce the implementation of fiscal consolidation, and no structure to help regenerate economic growth or address imbalances within the Euro-system." He and his associate Senior Economist Andy Cates estimate that the required fiscal tightening in OECD countries could lower global GDP by 2% in the first year and result in below trend growth for two years. They also point out that the rise in risk premiums, if sustained, could offset the effects of low interest rates and lower long term global growth by 1% per annum. Lower growth equals falling tax revenues and higher deficits until fiscal conditions reach a more sustainable sub 3% debt to GDP level.

- The draconian adjustments needed to address the insolvent status of the western transfer payment system will test the will of both political and civil society. As noted by German economist Jurgen Stark and evidenced by violent riots in Greece and the emergence of nationalistic, far right political parties: "There is no doubt that the crisis will leave us a heritage of severe macroeconomic imbalances … dealing with them will represent one of the most daunting challenges for policy makers in modern history." As a contrarian investor, we believe that when things get really bad for people they change their behavior and recovery begins. Our investment discipline positions us well to take advantage of the coming turmoil, but it does seem a bit early in the process of recognizing the challenges ahead…more of a cliff of complacency than a wall of worry right now.

- Awareness of the actual impact of invoking Article 122 of the Lisbon Treaty should begin to increase and could create problems among the people of non-Euro countries such as Britain, Sweden, and Poland. President Sarkozy of France announced last Saturday the decision to invoke Article 122 without even a vote by non-EMU countries, basically stating that he had enough votes to require non-Euro zone taxpayers to guarantee and fund subsidies to the weaker Euro zone countries. Britain could invoke something called the "Luxembourg compromise" and veto the demand on the grounds of an overriding national interest as they are more indebted than the Greeks. The strategists at GaveKal Limited characterize this as "a tremendous loss of sovereignty for all European nations." Basically the socialists of France and Belgium are in charge…I feel better already!

- The ECB and most European central banks need the SPV paper they give in exchange for the toxic country debt to be AAA rated. You may think this will prove difficult, but they plan to set up their own credit rating agency. I can't think of a case where this kind of arrangement created trouble in the past, can you? Ugh.

- In the end, a plan to save the Euro zone countries from default can work if the ECB stands ready to buy unlimited amounts of toxic bonds, especially from European banks and Germany is willing to foot the bill. Then, a massive program of deficit reduction and structural reform must take place. Deficit increases in the near term are unstoppable so anything short of these measures will keep the markets vulnerable to recurring solvency worries. It seems to me that a simpler solution would be to restructure and reduce the debt of countries that have no chance of ever paying it back and deal with the haircut directly, but I don't sit in Brussels. The truth is that most western democracies have made promises they can't keep and papering over this lie with debt has reached an end.

- As to the 1000 point intraday drop in the Dow — it appears that a mix of high-frequency noise traders all heading in the same direction and one huge bearish option bet on the S&P 500 triggered a ripple effect. The Wall Street Journal cited the trading desks at Barclays and a firm called Universa, which bought 50,000 options contracts that could make $4 billion if the S&P hit 800 by June of this year. As the market dropped, the people on the other side of this trade (betting the market would rise) were forced by their algorithms to sell more shares and reduce net exposure, creating selling pressure and removing liquidity at the same time. I suspect this might be a reasonable technical explanation, but after a historic 12 month rally with valuations, expectations and bullish sentiment all high, the market was clearly vulnerable to any unsettling news.

- I remain concerned that the next shoe to drop is a growth scare in China. Chinese stocks continue to decline, led by the most cyclical companies. We believe that there is clear evidence that stimulus spending is peaking, inflation is rising, liquidity is tightening and that the Chinese have overbuilt everything from iron ore inventories to condos. Europe also faces an inevitable slowdown as government spending is slashed while a seemingly decent expansion in the US is built upon the shaky ground of temporary incentives, easy comparisons and transfer payments. This seems a tough environment in which to deliver record earnings and margins as analysts are forecasting this year and next. It is a logical fallacy that everyone can gain market share, cut costs, raise prices and grow exports, but that is the consensus belief. Even if the global economy grows, it seems the markets remain vulnerable to earnings disappointments. This is consistent with the sideways market environment we have written about in past notes as a bear market in margins and multiples keeps stock prices range bound. The trick is to beat-the-fade on profits and valuations by remaining disciplined and buying only when both of these factors are depressed. A little yield and dividend growth does not hurt either.

Ultimately, our investment team continues to focus on disciplined concepts like valuations, earnings, dividends, free cash flows and resilient business models. The result is a portfolio that seeks to gain significant relative ground in rotational or corrective down markets and still participate nicely when the market is advancing.

Best Regards,

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