Legg Mason
GLOBAL ASSET MANAGEMENT

Legg Mason
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WHAT TO WATCH IN 2015

Themes and trends that could shape the markets

2015

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Investors found much to puzzle over last year, with many markets advancing smartly despite a host of macro disruptions — all the more reason to keep a watchful eye on the issues that could make a difference in 2015.

See for yourself in the following pages what the experts at Legg Mason's diverse family of investment managers are watching for, and believe could be crucial as the year unfolds — some familiar, some unexpected, all worth a careful look.

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WESTERN ASSET

Risk-adjusted returns

In pursuit of risk-adjusted returns, we believe investors will continue to demand diversified portfolios in 2015. We expect that long-dated US Treasury bonds will provide the best diversification for risk positions in 2015. If global growth were to slow — which we do not expect but also cannot entirely rule out — investor demand for "safe-haven" assets would lead to an increase in the value of these bonds. In such an environment, strong foreign demand would help boost prices of US Treasury bonds because US bonds offer a higher yield than other developed market sovereign bonds.

Long-dated US Treasury bonds will also benefit from the dis-inflationary environment that we expect in 2015. The combination of a stronger US dollar, lower oil prices, and muted wage growth will continue to put downward pressure on inflation. The prospect of muted inflation, with the risks tilted towards inflation moving even further below the Fed's target, will continue to keep bond yields low, thereby supporting bond prices.

Global growth

We believe the global economy will continue to expand in 2015, aided by accommodative central banks and improving private demand. Many central banks will continue to ease monetary policy in 2015, including the European Central Bank and the Bank of Japan. Even as the Federal Reserve (Fed) increases interest rates, we expect monetary policy in the United States to remain very accommodative with rates well below normal and the Fed's balance sheet much larger than normal. Accommodative monetary policy will provide an impetus to growth, while also supporting financial markets.

We also expect private demand to continue deepening in 2015. Lower oil prices provide a significant boost for private consumption, especially in the United States, where the savings rate is relatively low and falling gasoline costs lead directly to increases in retail spending. We expect growth in Europe to stabilize, due to improved capacity in the banking system and some labor market reforms. We expect China will manage a soft-landing, and that recent policy changes in certain emerging market economies, including Mexico, will lead to increased efficiency and output.

Broadening global growth will be favorable for many sectors, including corporates, mortgages, and emerging markets, which will benefit from the additional yield relative to Treasuries, as well as from improvements in the credit quality of underlying entities.

BRANDYWINE GLOBAL

G3 currencies

Central bank liquidity and growth considerations should continue to dominate G3 currency markets in 2015. We expect the US economy will continue accelerating on the back of strong private-sector expansion, ultimately allowing growth to gradually replace liquidity as the economy's paramount support.

By contrast, Japan and Europe, both beset by structural headwinds, will likely require further currency depreciation, labor reform, and positive external surprises before liquidity support can safely be removed. Japan's now-delayed consumption tax increase — designed to pay down the country's massive debt — would have further compounded the challenge of reaching economic lift-off speed. The major challenge facing Europe is the sub-optimal currency union, which we believe will weigh on growth expectations and confidence for the foreseeable future. Without differential interest rates or currency valuations to balance competitiveness across many unique European economies, the currency union requires elected governments to lead the competitiveness push — a formidable charge. That said, a cheaper euro will be an integral part of speeding up Europe to the extent that's possible.

Emerging market debt

In our view, higher-yielding local-currency emerging market (EM) debt will provide the most attractive value in 2015. EM currencies and bond yields, especially in countries needing to finance persistent current account deficits like Brazil, Indonesia, India, and South Africa, now offer elevated risk premia because investors are fearful of slowing global growth and a potential repeat of past crises. But EM fundamentals and global monetary policy conditions are different in the current cycle. In past EM routs, G3 central bank tightening decreased demand for higher-yielding EM assets — and encouraged volatility as investors sold EM portfolio investments. In the current cycle, because the 2008 deleveraging cycle was so powerful, we believe G3 rate hikes will be gradual, and will end with rates at very low levels, ultimately making higher yields in emerging markets too attractive for markets to dismiss.

In addition to a benign G3 tightening schedule, EM fundamentals are much improved from past crises: stronger central bank credibility, a deeper commitment to low inflation, larger forex reserves, ambitious structural reform, greater reliance on local-currency debt, more liquid markets, and more institutional investment — which tends to be stickier.

CLEARBRIDGE INVESTMENTS

Capital efficiency

US corporations have a record $10 trillion in cash on their balance sheets. How they allocate that cash and other capital assets should impact earnings, stock prices and value creation. As many companies continue to have difficulty generating organic revenue growth, we expect to see a continuation of M&A activity across most sectors of the economy. Low interest rates have enabled financing of acquisitions at attractive terms, and the threat of higher rates in the years ahead may speed up deal-making. In addition, we expect to see a continuation of companies disposing of non-core assets through spinoffs or asset sales.

Healthy balance sheets and still-low payout ratios should also lead to solid dividend growth, extending the "Golden Age of Dividends" we first recognized over a year ago. We will be closely following corporate use of share buybacks as a means of improving earnings per share. While incrementally positive for equity markets, we remain wary of companies overpaying for their own shares as stock values rise.

Japan stocks

The widening gap between return on equity and price-to-book value, present in Europe and parts of Asia, is especially widespread in Japan. Such gaps between price and value open up due to a painful period of economic transition or investor pessimism, conditions that currently fit a Japanese economy that has fallen back into recession.

While skepticism about the efficacy of the country's aggressive stimulus program is well deserved, we believe it ignores real change in company governance toward creating shareholder value. While this transition has just begun, Japan is already experiencing the best earnings and dividend growth in the developed world. This fundamental improvement has yet to be discounted in share prices, with valuations remaining among the lowest in the world. We believe low expectations for improvements in profitability and growth set the scene for continued upside surprises in Japan.

ROYCE & ASSOCIATES

Small-cap volatility

Small-caps have seen a number of corrections recently. Through 6/30/14 they had not had a double-digit correction for almost two years and not experienced one greater than 12% in more than three. But in the fall of 2014, the Russell 2000 Index saw its biggest correction since 2011. The third quarter of 2014, moreover, saw the first negative quarter for the small-cap index in the last nine.

These corrections did not worry us. A closer look inside the small-cap index reveals that 49% of its constituents were down at least 20% from their respective 52-week highs as of the end of September. And more than one in ten–11% — are off more than 30% over the last 12 months. To us, this shows the correction has been rotational — it has been going on, quietly, for a long time. Our examination of the index suggested that the rotation left many high-quality small-cap stocks still undervalued.

Active management

For many investors, volatility is synonymous with risk. But as value investors (and risk managers), we have always viewed volatility as a crucial component of active stock selection. Our recent research explored the relationship between low- and high-volatility environments and the relative performance of active managers versus their respective benchmarks during these periods.

Looking back at our more than 40 years of investment experience, we think there can be little argument that active managers have the potential to achieve benchmark-beating long-term returns. A recent study from S&P Dow Jones Indices[1] and our own research suggest the ideal market environment for active management is when securities are more likely to be mispriced and markets less efficient. Using history as our guide, we find that this type of market volatility is cyclical. It seems likely that as those market gyrations return, so will the opportunity for active managers to shine. We also believe that active management should gain an advantage when the market is led by earnings and other business fundamentals.

Royce&Associates

1 "S&P Index Versus Active" or SPIVA,® S&P Down Jones Indexes

MARTIN CURRIE

Value vs. quality

This past year has been marked by the strong performance of stocks which have characteristics associated with 'value' investing — deep valuation discounts, among other measures. We believe in the rush to exploit an expected economic recovery, most notably in Europe, macroeconomic factors have influenced the perceived attractiveness of these stocks at the expense of quality names. The cauterisation of the banking crisis and the support of sovereign bonds caused a dramatic compression of peripheral sovereign bond yields, rapidly improving overall business expectations of stocks with relatively weak fundamentals. But overall earnings momentum does not support this confidence.

Our preference is for identifying companies that can sustain their cashflows and maximise shareholder return, which tacitly tilts us towards 'quality' stocks. The current expected upside in many economies that is driving the performance of 'value' is still uncertain as growth in Continental Europe remains, at best, anaemic. But we believe companies that can sustain their cash flows and maximise shareholder returns over the long term, some with exposure to growing emerging market economies, are best placed to prevail in this uncertain economic landscape.

Europe turnaround

The disadvantages, pain and political impact of Europe's struggle to reform its economies and cost structure are well known. What's less appreciated — and likely not yet reflected in share prices — is the potential advantages that may accrue to companies doing business in that same environment. One example: the combination of rampant unemployment and the mobility of labour within the EU have had the effect of driving unit labour costs down in parts of peripheral Europe, to the dismay of many but to the advantage of employers trying to compete in a difficult global economy. Countries with stubborn labour cost environments, not matched by improving productivity — France and Italy, for example — have had the most trouble in the current post-2008 economy. If labour reforms gain momentum, the improvements could continue — potentially boosting employment levels as well. The potential benefit of a more open-handed European Central Bank, as well as the heavily promoted €300 bn ($374 bn) infrastructure fund and the declining euro could add up to a solid year for select European companies as the improvements take hold toward the latter part of the year.

PERMAL

Global divergences

We are seeing both divergence of economies and divergence of markets. For example, year-to-date, the American and Chinese markets are up around 10%, while most European markets are up about 1%, and emerging markets are up somewhere around 6% and Japan down 2%. It is an environment where at least one major economy, the United States, is moving toward normality and has emerged as the driver of global growth. But we are also in an environment where geopolitical unease is rising all the time.

Emerging market equity markets are also diverging. On one side, there are those countries which need rapid Chinese growth to continue because they are essentially driven by exports of natural resources to China, including Chile, Peru, and to a certain degree Brazil. On the other side are countries far less dependent on China, namely Mexico, Korea, Indonesia, Malaysia and Philippines. These countries should do better from an equities standpoint and have more room to stimulate. They do not have inflationary issues that China trade is causing, for nations such as Chile. Increasingly, we are seeing these regions bifurcate with Mexico benefiting from the US economy, while the likes of Brazil are in a far tougher spot.

A normalizing world

As the world normalizes, it allows managers to use their entire skillset, instead of dealing in a world where artificially managed interest rates cause risk and return to be mispriced. A normal world for managers is much better than an artificial one. Divergence of economic conditions creates many interesting trading opportunities, in currencies, fixed income, country vs. country from an equity standpoint, or even a particular country's equity market between winning and losing sectors.

For credit, there has been a major shift in people's mindset. Going forward, if we are correct, it is going to be a lot harder to succeed in conventional credit. The use of macro strategies in the fixed income space is something we will be focusing on more and more. The opportunities in credit are likely to be very specific, in our view. With higher US interest rates, in our opinion, come a higher number of defaults — and struggling companies will find it difficult to sustain themselves. We are right at the cusp of a major change. That's not to say credit will become catastrophic, but it is likely to be much harder to generate real returns going forward.

QS INVESTORS

Abenomics and Asia

If Abenomics doesn't work, the huge sucking sound coming from Japan could challenge economic growth in all of Asia. Japan's central bank understands the stakes. Reacting to the recent drop in GDP and oil prices, the Bank of Japan (BoJ) added to its "quantitative and qualitative monetary easing" in October, raising its commitment to about ¥80tn ($678bn) — an addition of ¥10-20tn — until its 2% price stability target is both "achieved and consistently maintained." By acting aggressively, the BoJ demonstrated to both investors and policy makers its commitment to reigniting inflation in the Japanese economy. In addition, a declining yen would allow Japan to be a more competitive exporter, and should boost inflation as well. In an apparent vote of confidence by financial markets, the yen declined and Japanese equities rose. The Government Pension Investment Fund (GPIF) joined in, announcing it would shift more assets out of bonds and into equities. Time will tell if these moves will help turn the tide.

ECB policy

Europe has its back against the wall, and will have to choose whether to be a hero or a zero. So far, the bold monetary policy moves of Japan have yet to find their match in the approach adopted by the European Central Bank (ECB), which has gradually infused liquidity into the economy through low cost loans to financial institutions. Because those loans are being repaid, in effect monetary conditions have tightened slightly in Europe over the past few years. Should economic growth continue to be anemic and inflation expectations continue to fall, the eurozone may have to choose between a deflationary spiral similar to what Japan went through in the 1990s or a more aggressive, full blown quantitative easing program, with direct purchases of government bonds.

LMM

Bond market liquidity

The past few years have created the possibility of potentially destabilizing illiquidity in the US bond market. The widely predicted end to the 30 year bull market in bonds did not happen in 2014, driving even more inflows into bond funds. The Fed, having accumulated over $4 trillion in bonds since 2008, removed itself from the market. Banks are leaving the markets as well; new liquidity and capital requirements have led them to hold ever larger amounts of bonds and bills. Corporate pension plans have shunned equities in favor of bonds, and individuals still fear risk and seek “safety” in bond investments. Two illiquidity tremors hit the bond market in the past 18 months. First, the so called “taper tantrum” doubled 10 year yields in less than 6 months. And in October, 10 year Treasury yields fell from 2.25% to 1.85% intra-day as liquidity evaporated. The bond market is exceptionally concentrated compared to equities; just a few investment firms hold an inordinate amount of the market. Should rates begin their long predicted rise in 2015, the bond market could get disrupted and suffer a destabilizing crash, not unlike the 1987 equity market.

US politics

The hyper-partisan atmosphere in Washington has resulted in gridlock, brinksmanship, and general political disfunction over the past 6 years. Although the Republicans were widely expected to pick up seats in the mid-term election, they not only cemented their control of the House, but won the Senate decisively and now hold a 53 seat majority. Perhaps more significantly, most of those newly elected were from the “establishment” wing of the Republican Party rather than its Tea Party faction, which eschews working with Democrats. With President Obama only having 24 months remaining, he has only a short period to cement his legislative legacy. If he decides to follow the example of former President Clinton and work with the opposition, the possibility of significant legislative progress exists. In addition to immigration reform (good for the high tech industry), and the approval of the Keystone Pipeline, the big win for capital markets would be comprehensive tax reform, especially the ending of the 35% corporate tax rate. Closing loopholes and ending corporate welfare could result in a maximum corporate tax rate of around 25%. The big winners: domestic industries such as housing.

* For example, “Growth in a Time of Debt,” Carmen M. Reinhart & Kenneth S. Rogoff, 2010, American Economic Review.

Investment risks

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Equity securities are subject to price fluctuation and possible loss of principal. Small-cap stocks involve greater risks and volatility than large-cap stocks.

Foreign securities are subject to the additional risks of fluctuations in foreign exchange rates, changes in political and economic conditions, foreign taxation, and differences in auditing and financial standards. These risks are magnified in the case of investments in emerging markets.

Fixed income securities are subject to interest rate and credit risk, which is a possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. As interest rates rise, the price of fixed income securities falls. High-yield bonds possess greater price volatility, illiquidity and possibility of default. Asset-backed, mortgage-backed or mortgage related securities are subject to additional risks such as prepayment and extension risks

US Treasuries are direct debt obligations issued and backed by the "full faith and credit" of the US government. The US government guarantees the principal and interest payments on US Treasuries when the securities are held to maturity. Unlike US Treasuries, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the US government. Even when the US government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.

Commodities and currencies contain heightened risk that include market, political, regulatory, and natural conditions and may not be suitable for all investors.

Mortgage-backed securities involve additional risk over more traditional fixed-income investments, including: interest rate risk, implied call and extension risks; and the possibility of premature return of principal due to mortgage prepayment, which can reduce expected yield and lead to price volatility.

Most alternative investment assets are held by institutional investors or accredited, high-net-worth individuals because of their complex nature, limited regulations and relative lack of liquidity. Alternative investments include hedge funds, managed futures, real estate, commodities and derivatives contracts, and may carry greater risk.

Definitions

A **risk-adjusted return** is a measure of performance relative to its level of risk exposure over a given period of time.

Mergers and acquisitions (M&A) is a general term used to refer to the consolidation of companies. A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed.

"Taper tantrum" refers to the financial markets' reactions, in May–June 2013, to the announcement by the Federal Reserve that it was planning to decrease, or "taper" its $70 bn per month bond buying program.

The **European Union (EU)** is an economic and political union established in 1993 by members of the European Community. The EU now comprises 28 countries after its expansion to include numerous Central and Eastern European nations.

Gross domestic product, or **GDP**, is the total market value of all final goods and services produced in a country in a given year.

"Abenomics" refers to a series of economic reforms proposed by Japan's Prime Minister Shinzo Abe.

The **Russell 2000 Index** is an unmanaged list of common stocks that is frequently used as a general performance measure of US stocks of small and/or midsize companies. Please note an investor cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Tapering refers to the Fed's announced approach to reduce the pace of its current $85 billion in monthly asset purchases gradually instead of ending the purchases all at once.

Risk premium is the excess return that the market offers for an asset class over a risk-free rate, usually the US 10-year Treasury note. This excess return compensates investors for taking on the relatively higher risk of that asset class.

Residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) are forms of asset-backed securities, holding pools of residential or commercial mortgages (respectively) used as collateral for the securities. Non-agency mortgage-backed securities (MBS) are those issued by private entities and not by federal agencies (Fannie Mae, Freddie Mac and Ginnie Mae); they are also called non-conforming loans.

The **European Central Bank (ECB)** is responsible for the monetary system of the European Union (EU) and the euro currency.

The **US Federal Reserve**, or "**Fed**," is responsible for the formulation of a policy designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

Duration is a measure of the price sensitivity of a fixed-income security to an interest rate change. It is calculated as the weighted average of the present values for all cash flows, and is measured in years.

G3 refers to an unofficial economic grouping of the world's top three developed economies: USA, Europe and Japan

Liquidity refers to the ability of an asset to be converted into cash quickly and without any price discount.

The **yield curve** is the graphical depiction of the relationship between the yield on bonds of the same credit quality but different maturities.

The **price-to-earnings (P/E) ratio** is a stock's price divided by its earnings per share.

The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the US An investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

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