LEGG MASON
GLOBAL ASSET MANAGEMENT

Market Review

The recovery in asset prices continued apace in January. Investors shrugged off concerns about the ongoing Greek debt negotiations, escalating political tensions with Iran, and the S&P downgrades of a select group of European sovereigns, resulting in strength across virtually every major asset class. A dovish statement from the US Federal Open Market Committee (FOMC) in January indicating a longer-than-expected extension of the low fed funds rate, combined with positive macro news, further fueled the rally. Across the fixed-income spectrum, both risky and "riskless" assets delivered positive returns. Volatility as measured by the Chicago Board Options Exchange Volatility Index (VIX) fell below its long-term average, reflecting some stabilisation of market risk appetite.

The latest EU summit made some progress toward a new fiscal compact, which aims to put the eurozone region on a path to reduce debt-to-GDP ratios to 60% over time. Meanwhile, International Monetary Fund (IMF) managing director Christine Lagarde, US Treasury Secretary Timothy Geithner and Italian Prime Minister Mario Monti discussed the possibility of combining the IMF, European Financial Stability Facility (EFSF), and European Stability Mechanism (ESM) rescue funds to create a super-firewall of over $1 trillion, but the plan faced huge resistance from Germany. As a result, EU leaders delayed their decision on the overall scale of the permanent rescue fund to the next formal summit in March.

The Greek debt-restructuring negotiations continued, with recent press reports indicating that the parties were nearing an agreement on a lower coupon that would in essence reflect a 72% haircut. Also, creditors pressured the European Central Bank (ECB) to accept a similar haircut on the Greek debt that it accumulated through its Securities Markets Programme; however, at this juncture the central bank remains detached from the negotiations.

In mid-January, S&P took action on 16 eurozone sovereigns, nine of which were downgraded. Most of these rating downgrades were widely expected and were already reflected in market pricing. In addition, S&P downgraded the EFSF from AAA to AA+. The prospect of fierce new sanctions on Iran escalated over the month, with the EU, which currently accounts for a fifth of Iran's overall sales, confirming its intent to halt oil imports from the region.

Leading manufacturing indicators were encouraging across the globe. While the US Chicago Purchasing Managers Index (PMI) reported a fall, the Institute for Supply Management's manufacturing index continued to trend upward. Even the PMI manufacturing data from Europe and the UK were surprisingly upbeat. India's manufacturing PMI surged for a second consecutive month, while China's PMI posted a modest increase. In the US, the advance estimate of 4Q11 GDP was 2.8%, up from 1.8% in 3Q11. In Germany, the economy contracted to 3.0% from 3.7% over the same period. GDP contracted by 0.2% in the UK after increasing by 0.6% the previous quarter. China's 4Q11 GDP came in as expected at 8.9%, down from 9.1% in 3Q11, with underlying data reflecting a moderation in growth, though there was little sign of the much-anticipated hard-landing scenario.

The US 10-year Treasury yield declined by 8 basis points (bps) to 1.80%, while the German 10-year bund yield declined by 4 bps to 1.79%. Spreads on Italian sovereign debt compressed sharply, with the spread of Italian 10-year issues falling 110 bps over equivalent-maturity German issues to reach a yield of 5.95%. Investment-grade credit spreads tightened to 32 bps, as measured by the Merrill-Lynch Global Broad Market Corporate Index. The financial sector within the investment-grade universe outperformed industrials and utilities by a wide margin. US and European high-yield spreads tightened 62 bps and 178 bps, respectively. The S&P 500 and Euro Stoxx-50 gained 4%. Emerging market (EM) currencies gained strongly against the US dollar, led by the Brazilian real and the Mexican peso.

Outlook

Our view that the global economy should continue to grow at a modest pace remains unchanged, though we recognise that greater complexities exist at a regional level. The latest IMF projections further substantiate our base-case scenario of solid but below-trend growth in the US, and it looks more probable that the Chinese economy will avoid the hard landing that many had feared. European fragilities remain the key risk to our baseline scenario.

In the US, it's reassuring to see the economy continuing to add jobs at a solid pace. Nonfarm payrolls were stronger than expected, and the unemployment rate fell to a three-year low of 8.3%. In contrast, unemployment levels in the eurozone remained at a 14-year high of 10.4%, though this masks huge divergence at the country level. In Germany, the unemployment rate fell to a 20-year low of 6.7%, while unemployment in Spain reached a high of 22.9%.

Policymakers continue to edge toward closer economic and fiscal integration. The latest European Commission (EC) summit revealed the details of the fiscal compact, which aims to reduce sovereign debt to 60% of GDP. While Germany's fiscal position already meets the new debt rule, the periphery will require large fiscal adjustments to reach these targets; this will weigh heavily on future nominal growth and likely will push unemployment levels even higher. The resulting outcome should be a sustained period of loose monetary policy by the ECB, consistent with our long-held view that the ECB needed to do more to help resolve the eurozone crisis. Rather than tightening in 2Q11, we felt the crisis warranted easier policy. It's reassuring to see recent measures such as the three-year Long-Term Refinancing Operation (LTRO) finally supporting risk sentiment. On top of the regional growth divide, event risk remains at the forefront, and while no concrete decision has been made on the Greek debt restructuring, this will remain the key focus in the month ahead and will undoubtedly create spells of volatility.

The US Federal Reserve (Fed) marked a major step toward greater transparency at the first FOMC meeting of the year. The FOMC released a formal statement of its policy objectives, which included an explicit inflation target of 2% (as measured by the Personal Consumption Expenditures Price Index). The FOMC also released fed funds rate projections, including its expectations of the appropriate year in which the rate will increase. The FOMC indicated that it expects economic conditions to necessitate the extension of the exceptionally low fed funds rate from mid-2013 to late 2014. Interestingly, the fiscal policy outlook is not so clear. The US Congress has extended the payroll tax cut and emergency unemployment benefits to two months; it is expected that a full-year extension will follow. However, if these measures are not extended to 2013, the full extent of fiscal tightening will have a negative impact on GDP growth. It is unlikely that Congress will push the economy toward such a path, but the possibility does create uncertainties for the long-term outlook.

Strategies that help protect portfolios against risks to our base-case scenario continue to play an important role within our overall investment strategy. We commit a lot of time and resources to managing the relative cost of protecting portfolios against tail risk, striving for adequate diversification in any number of scenarios. As liquidity improved markedly over the month, we reduced the size of our overweight to subordinated European financial issues. While we remain compelled by valuations in the financial subsector, we have shifted our exposure toward issuers domiciled in the US and the UK. While focusing on balances to overall risks, we also reduced the size of our overweight to Poland and Italy.

In currency strategies, we continue to favour a short euro position against a diversified basket of EM and trade-surplus currencies. We remain constructive on emerging markets as a long-term secular theme that offers exposure to strong fundamentals. Changing demographic trends in the developing world should continue to stoke greater consumer demand in this evolving group of countries. Moreover, new global champion companies from the developing world should increasingly make their presence known on a global scale.

To hedge against credit risk, we continue to run an overweight duration position relative to the benchmark. We maintain an overweight duration in Europe, targeting interest rate risk at the intermediate part of the curve. In the US, we maintain a tactical underweight. We recently added more duration in longer-dated UK gilt issues to further calibrate overall duration positioning. On country allocation, while we maintain a close to duration-neutral exposure, we are overweight Italy; this is balanced by an underweight to the rest of the peripheral bloc.