

Stocks Rally Following Mid-Month Correction to Post Gain in March

Market Review

Showing remarkable resilience in the face of monumental human tragedy in Japan and continued unrest in the Middle East, the S&P 500 Index eked out a sliver of gain in March, returning +0.04%. Except for the S&P 100 Index, all of the other U.S. equity indices we track also posted gains for the month.

| U.S. Indices – Total Returns in US Dollar Terms (%) | | |
|-----------------------------------------------------|--------|--------|
| | March | YTD |
| S&P 500 Index | +0.04% | +5.92% |
| Dow Industrials | +0.91% | +7.07% |
| Nasdaq Composite Index | +0.02% | +5.05% |
| S&P Mid-Cap Index | +2.45% | +9.36% |
| Russell 2000 Index | +2.59% | +7.94% |
| Dow Jones US Total Return Index | +0.39% | +6.06% |
| S&P 100 Index | -0.41% | +5.29% |
| Russell 1000 Growth Index | +0.12% | +6.03% |
| Russell 1000 Value Index | +0.40% | +6.46% |

Sources: Wilshire, Russell®, NASDAQ® (via Bloomberg), S&P (via Bloomberg), as of 31 March 2011.

Contrary to first appearances, March was anything but a tranquil month for stocks. The U.S. equity market – which was already in the early stages of a mild correction attributed primarily to increasing tensions in the Middle East and North Africa – was rocked on Friday, March 11, by a massive, 9.0-magnitude earthquake off the east coast of Japan. The resulting tsunami, with waves reaching 124 feet in height, struck the island nation minutes later, devastating large swathes of the country’s Honshu province and in some cases traveling up to six miles inland.

After an initial downdraft, the U.S. equity market absorbed news of the earthquake and tsunami with surprising equanimity, actually closing up on the day it hit. Only after reports surfaced over the following weekend and early the next week that the tsunami had severely damaged a nuclear power plant in the prefecture of Fukushima, located roughly 150 miles north of Tokyo, did the U.S. stock market become unsettled. As it struggled to discount the potential for a

nuclear accident at Fukushima, the S&P 500 fell for three straight days, bottoming on Wednesday, March 16, at 1,249.05 on an intra-day basis and 1,256.88 at the day’s close. Those levels marked declines of -7.1% and -6.4%, respectively, from the S&P 500’s intra-day and closing highs since the ‘09 market bottom, reached on February 18. Remarkably, given the continuing uncertainty surrounding the severity of the situation at Fukushima, the S&P 500 rallied +5.5% from its March 16 bottom through month-end, rising on eight of 11 days.

So, was that it? Has the market correction we and others had been anticipating, come and gone? As comforting as that would be, we very much doubt that this is so. The market is coming off its best first quarter since 1998 so a pullback would not be surprising. We think there is a reasonable chance the S&P 500 will retest the 1,200 to 1,250 level at least once before it fully discounts the fallout from the earthquake, tsunami and nuclear crisis in Japan as well as the continued impact from the unrest in the Middle East and North Africa. At that level, it would be ready to resume its advance to what we continue to regard as a realistic year-end target of 1,400 to 1,450.

Before offering our thoughts on why the market might not be completely through its corrective process, we thought it might be useful to discuss why, in our view, the market has been so surprisingly strong in the face of an onslaught of discouraging news. In a word, we believe the answer is “regret.” We think investors have finally realized they have been too negative on the stock market over the last two years, regret missing the near doubling of the S&P 500 over that time period, and have been hoping for a correction in the market to put more money to work. That view is supported by data on mutual fund flows from The Leuthold Group, LLC, which show net inflows of US\$40.5 billion into U.S. focus equity mutual funds this year through March 30. Moreover, Leuthold’s data indicates flows into U.S. equity funds again turned strongly positive for the week ending March 30 after turning negative for the two weeks ending March 23, suggesting that investors are now more willing to “buy the dips” than they have been in previous corrections. It appears that investors are growing weary of earning next to nothing in money market funds and are learning, or relearning, the

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lesson that they can lose money in bonds. In short, we think more investors are coming to agree with veteran hedge fund manager Leon Cooperman's recent comments on CNBC where he noted, "at worst, stocks are the best house in a bad neighborhood" and might even be "the best house in a good neighborhood."

Another obvious reason why stocks have been so strong is the sharp rebound in corporate profits. S&P 500 earnings are forecast to exceed their prior 2007 peak by several dollars per share in 2011 and reach even higher levels in 2012. Still, the S&P 500 trades around -15% below its all-time closing high of 1,565.15, reached on October 9, 2007. Since interest rates are much lower today than they were in 2007, one could reasonably argue the S&P 500 should be trading above its old high rather than at its present discount.

Outlook

Since the market remains at about the same level it was a month ago, we find ourselves feeling similarly about the outlook. We continue to believe the S&P 500 Index has about +5% to +10% upside through year-end 2011, to a range of 1,400 to 1,450. We also believe the market has downside risk of -5% to -10%, to 1,200 to 1,250 over the next couple of months. The S&P 500's March 31 close of 1,325.83 translates to almost exactly 100 points of upside and downside to the midpoints of those respective target ranges. As was the case last month, the resulting near-term reward-to-risk ratio at 1-to-1 is not especially compelling. It is important to note, however, that the reward-to-risk ratio is highly sensitive to relatively modest market movements. For example, at its intra-day bottom of 1,249 on March 16, the S&P 500 – using the mid-points of the target ranges described above – had 176 points of upside and 24 points of downside for a much more compelling reward-to-risk ratio of 7-to-1. It was thus entirely rational that investors stepped in to take advantage of the pullback. We believe that any subsequent correction, should it occur, would likely prove to be equally rewarding.

There is a reasonable case to be made that our year-end target range of 1,400 to 1,450 for the S&P 500 Index is too conservative. After all, bottom-up consensus estimates for the S&P for 2011 and 2012 are US\$98.04 and US\$111.52, respectively, according to Thomson Financial. Our internal discounted cash flow (DCF) model puts the fair value multiple of the S&P 500 at 16.6 times, using fairly conservative assumptions of 5.5% long-term earnings growth, 13% return on invested capital, and an 8% weighted-average cost of capital (consisting of a 3.5% 10-year U.S. Treasury plus a 4.5% equity risk premium), implying a fair value range for the S&P between 1,627 and 1,850, using consensus estimates. Even assuming, as is certainly possible, that 10-year Treasury yields rise to 4.5% over the next year or so, the S&P 500's

theoretical fair value range would still be 1,350 to 1,537, using the same earnings estimates and assumptions listed above. This suggests the market can tolerate a meaningful rise in interest rates and still make upward progress.

A number of factors temper our bullishness from what a pure mathematical analysis of the market's upside might suggest. The first set of concerns is raised by John Mendelson, veteran market technician at Potomac Research Group. In a March 29 "View of the Market," Mendelson called the quality of the rally since March 16 "poor" because trading volume during the advance was light and declining. Mendelson was further concerned by the fact that his proprietary "Last Hour Indicator" was much weaker than the overall market during the advance, suggesting to him that professional investors were selling into the rally. Finally, Mendelson continues to be troubled by the poor relative strength of financial stocks, which he has often said needs to be "in the game" for a market rally to be considered healthy.

Another aspect of the market we find troubling so far this year is the narrowness of its leadership. Basically, energy stocks have been the only game in town. In the first quarter, energy stocks in the S&P 500 were up +16.79%, outperforming the index by nearly 11 percentage points. Industrials also outperformed the index for the quarter, by just less than 3 percentage points. Other than that, all other eight sectors trailed the index for the quarter, with consumer staples, utilities and financials notably weak.

As far as the economic outlook is concerned, we see reasons to temper our prior expectations a bit. Payroll employment growth of 216,000 in March was a welcome shot in the arm, but much other recent data points to a slowdown in economic growth in the first quarter. In an April 4, 2011, piece entitled "Not so Fast," Lyle Gramley, a former Fed governor and senior economic advisor at the Potomac Research Group, noted a slowing in consumer spending in January and February to an annual rate just +1.0% above the fourth quarter level. He further observed that fixed investment by businesses also "appears to have subsided in the first quarter" and that the housing industry remains notably weak. Gramley concludes: "With consumer buying, cap ex, and housing all showing signs of weakness, first quarter GDP probably rose at an annual rate of around +2.25%, down from the +3.1% pace of the final three months of 2010."

The fallout from the earthquake, tsunami and nuclear crisis in Japan is unlikely to have a significant negative impact on the U.S. economy, but the impact will almost certainly not be positive either. Japan's real GDP growth may fall to zero in 2011 from a prior expected level of about +1.5%. If so, this fall will knock about 10 to 15 basis points off global growth in 2011, since Japan accounts for about 8.7% of global GDP. We see supply chain disruptions – especially among tech and

auto companies – as being the most likely source of problems for U.S. companies over the next quarter or two. It remains to be seen how forgiving the market will be if these problems crop up.

While the scale of the human tragedy from the combined effects of the earthquake, tsunami and nuclear crisis in Japan are nearly unfathomable, we think the near-term course of the U.S. equity market is likely to be more strongly influenced by the outcome of two events playing out in our nation's capital. The first is the likely impact on financial markets, particularly the U.S. Treasury market, of the end of the Fed's current round of quantitative easing (QE2). The second is the ultimate resolution of the battle in Congress over approval of the 2011 budget, negotiations to raise the debt ceiling, and efforts to reduce the structural imbalance in the U.S.'s long-term finances.

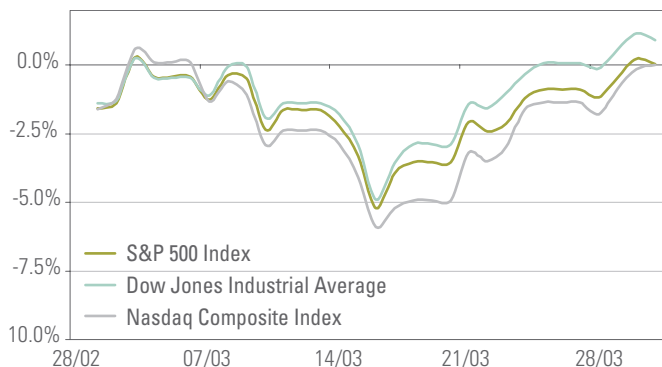
PIMCO co-CIO Bill Gross offered a cogent look at the first question in his March investment outlook entitled "Two-Bits, Four-Bits, Six-Bits, a Dollar." Gross's analysis was elegant in its simplicity. He used three pie charts to show: (1) Who owns the outstanding stock of Treasuries, (2) Who has been buying them recently, and (3) Who will buy them when the Fed ends QE2. According to Gross, of the US\$9 trillion of publically issued Treasury notes and bonds, foreign central banks and sovereign wealth funds own 50%, the Fed owns 10%, and private market investors (bond funds, insurance companies, banks and individuals) own the other 40%. More strikingly, Gross's view is that since the beginning of QE2, the

Fed has purchased roughly 70% of the annualized issuance of Treasuries with foreign sovereigns absorbing the other 30%. Gross asks readers to ponder the question "Who will buy Treasuries when the Fed doesn't?" His answer is that he doesn't know, but he thinks whoever does will likely demand higher rates than those currently prevailing in the market. In our view, it's hard to argue with his logic.

Whenever we consider the bizarre workings of the U.S. Congress, two famous quips come quickly to mind. The first is the one about the two things you don't want to see being made, sausage and legislation. The second is comedian Lily Tomlin's classic: "I try to be cynical, but it's hard to keep up." We have previously lamented the lack of statesmanship among our congressional leaders. The House and Senate have been arguing for weeks over whether to approve a 2% or a 4% cut, equal to no more than US\$61B, in the coming federal budget while the projected budget deficit runs over US\$1T. Space does not permit a full explication of this issue here, but suffice it to say we believe closing the structural deficit in the federal budget is a key, and perhaps the key, issue facing the U.S. equity market over the next three to five years. Satisfactory resolution of this issue could set the stage for a multi-year bull market. Failure to do so could have dire consequences for the economy, the financial markets, and the country.

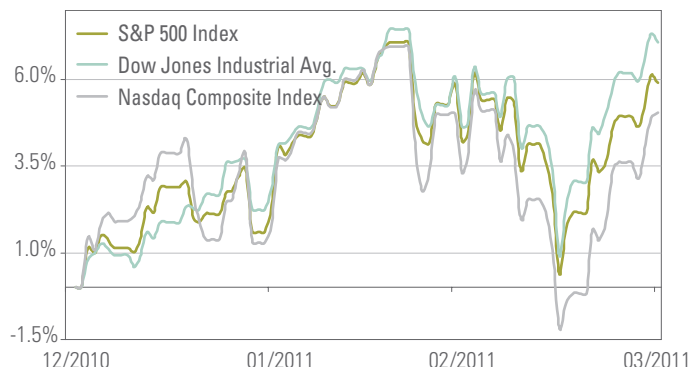
As always, we thank you for your support and welcome your comments.

Major Indices March Performance



Sources: Dow Jones, NASDAQ® (via Bloomberg), S&P (via Bloomberg)

Major Indices Year-to-Date Performance



Sources: Dow Jones, NASDAQ® (via Bloomberg), S&P (via Bloomberg)

Monthly U.S. Market Update (Total Returns)

| Index Name | March | YTD |
|----------------------------------------------------------|--------|--------|
| Broad Market Indices | | |
| S&P 500 | 0.04% | 5.92% |
| Dow Jones | 0.91% | 7.07% |
| Russell 1000 | 0.26% | 6.24% |
| NASDAQ | 0.02% | 5.05% |
| Dow Jones US Total Market Index | 0.43% | 6.37% |
| Russell 2000 | 2.59% | 7.94% |
| Russell 1000 Growth | 0.12% | 6.03% |
| Russell 1000 Value | 0.40% | 6.46% |
| S&P 500 Sector Indices | | |
| S&P 500 Consumer Discretionary | -0.52% | 4.71% |
| S&P 500 Consumer Staples | 1.62% | 2.52% |
| S&P 500 Energy | 1.53% | 16.79% |
| S&P 500 Financials | -2.56% | 3.06% |
| S&P 500 Health Care | 1.89% | 5.62% |
| S&P 500 Industrials | 1.78% | 8.75% |
| S&P 500 Information Technology | -2.61% | 3.47% |
| S&P 500 Materials | 1.87% | 4.54% |
| S&P 500 Telecomm Services | 5.28% | 4.85% |
| S&P 500 Utilities | 0.23% | 2.78% |
| Non-U.S. Indices – Returns in US Dollar Terms (%) | | |
| FTSE 100 Index (Great Britain) | -2.02% | 4.38% |
| DAX Index (Germany) | -0.38% | 8.96% |
| CAC 40 Index (France) | -0.15% | 11.33% |
| MICEX Index (Russia) | 3.66% | 15.59% |
| NIKKEI 225 (Japan) | -8.51% | -5.05% |
| Hang Seng Index (Hong Kong) | 1.27% | 2.40% |
| Kospi Index (South Korea) | 11.32% | 5.72% |
| Shanghai SE Composite (China) | 1.16% | 4.94% |
| BSE Sensex 30 Index (India) | 10.79% | -4.87% |

Sources: Dow Jones, Russell®, NASDAQ® (via Bloomberg), S&P (via Bloomberg), as of 31 March 2011.

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