

LEGG MASON CLEARBRIDGE SELL-OFF OVERLOOKS SOLID LONG-TERM TRENDS



Jeff Schulze, CFA
Investment Strategist

The current sell-off is overdone, notes Investment Strategist Jeff Schulze: inflation fears have been heightened by investor complacency, and the market can handle higher rates if the rise is not too rapid.

- The current equity sell-off has been triggered by fears of higher inflation and higher interest rates that have been exacerbated by investor complacency.
- We believe the selling is overdone and that the market can handle higher rates if the ascent is not too rapid.
- Long-term volatility measures suggest investors are willing to look past short-term price swings and focus on solid economic growth as a driver of equity performance.

Treasury yields have been steadily rising since September – and until late January, equity markets had been digesting this move with little trouble. However, a spike in interest rate volatility over the last two weeks, exacerbated by strong wage inflation data from the January jobs report, has led to the largest equity sell-off in two years. Average hourly earnings came in at 2.9%, the highest level since 2009, causing some to question if inflationary pressures are about to rise, and whether the Fed may be behind the curve.

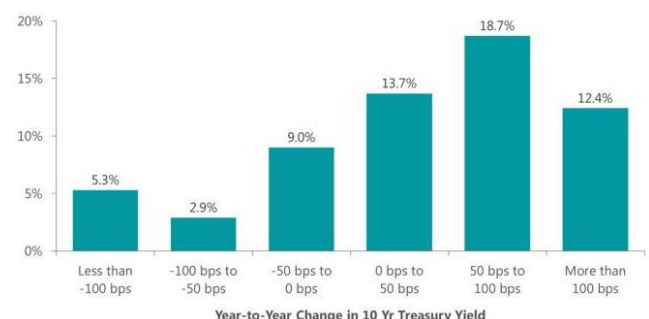
In our view, the market has overreacted to these events. We believe the real culprit behind the recent sell-off has been investor complacency. Prior to last week, the market had not seen consecutive daily declines for 310 days. Further, the record streak of days without a 5% correction was only broken yesterday. These types of streaks are rare and are typically followed by heightened volatility as fear begins to percolate back into investor minds.

To put in perspective how content investors had been acting, it's best to look at sentiment surveys like the Investor Intelligence Bull/Bear Ratio. Last week, this measure was at 5.24, its second highest reading of all time.

With complacency the real driver behind the equity sell-off, we believe the market can handle somewhat higher rates in the coming months as long as the ascent is not too rapid.

Our 2018 outlook highlighted rising interest rate and equity volatility as key themes. We felt that interest rates would rise for several reasons, including a doubling in Treasury issuance from 2017, rising inflationary pressures, stronger economic growth (with a tailwind from tax reform) and a wind-down of the ECB's QE program. Since bottoming in early September, 10-year U.S. Treasury yields have risen 80 basis points. Despite rising interest rates, the S&P 500 has risen 16.4% during the previous six periods since 1990 when short-term rates have increased by 125 basis points or more since 1990.

Stocks Can Withstand Higher Interest Rates (S&P 500 Average Rolling 1-Year Performance Based on Treasury Yield Change)

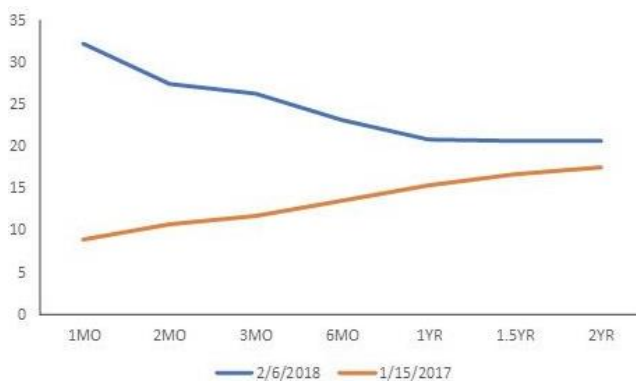


Source: BMO Capital Markets, Bloomberg, Federal Reserve Board. Based on monthly data from Jan. 1, 1990 through Jan. 31, 2018.

FOR PUBLIC IN HONG KONG AND DISTRIBUTORS IN MACAU USE ONLY. PLEASE REFER TO THE IMPORTANT INFORMATION ON THE FINAL PAGE.

While volatility has spiked, with the VIX rising to its highest levels since 2011, it is important to distinguish between short-term and long-term volatility. While the VIX has surged, derivative contracts for longer-term volatility have seen a much more muted move. This tells us investors are willing to look past the short-term market action and expect volatility to fall from current levels as the market re-focuses on stronger economic growth in the U.S. and abroad.

Implied S&P 500 Volatilities by Time Period, 2/6/18 vs 1/15/17



Source: Bloomberg.

Brandywine Global

Clarion Partners

ClearBridge Investments

EnTrustPermal

Martin Currie

QS Investors

RARE Infrastructure

Royce & Associates

Western Asset Management

Legg Mason is a leading global investment company committed to helping clients reach their financial goals through long term, actively managed investment strategies.

- Over US\$767 billion* in assets invested worldwide in a broad mix of equities, fixed income, alternatives and cash strategies
- A diverse family of specialized investment managers, each with its own independent approach to research and analysis
- Over a century of experience in identifying opportunities and delivering astute investment solutions to clients

* As of 31 December 2017.

IMPORTANT INFORMATION:

All investments involve risk, including possible loss of principal.

The value of investments and the income from them can go down as well as up and investors may not get back the amounts originally invested, and can be affected by changes in interest rates, in exchange rates, general market conditions, political, social and economic developments and other variable factors. Investment involves risks including but not limited to, possible delays in payments and loss of income or capital. Neither Legg Mason nor any of its affiliates guarantees any rate of return or the return of capital invested.

Equity securities are subject to price fluctuation and possible loss of principal. Fixed-income securities involve interest rate, credit, inflation and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed income securities falls.

International investments are subject to special risks including currency fluctuations, social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets.

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

Past performance is no guarantee of future results. Please note that an investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

The opinions and views expressed herein are not intended to be relied upon as a prediction or forecast of actual future events or performance, or a guarantee of future results, recommendations or advice. Statements made in this material are not intended as buy or sell recommendations of any securities. Forward-looking statements are subject to uncertainties that could cause actual developments and results to differ materially from the expectations expressed. This information has been prepared from sources believed reliable but the accuracy and completeness of the information cannot be guaranteed and is not a complete summary or statement of all available data. Individual securities mentioned are intended as examples of portfolio holdings and are not intended as buy or sell recommendations. Information and opinions expressed by either Legg Mason or its affiliates are current as at the date indicated, are subject to change without notice, and do not take into account the particular investment objectives, financial situation or needs of individual investors.

The information in this material is confidential and proprietary and may not be used other than by the intended user. Neither Legg Mason or its affiliates or any of their officer or employee of Legg Mason accepts any liability whatsoever for any loss arising from any use of this material or its contents. This material may not be reproduced, distributed or published without prior written permission from Legg Mason. Distribution of this material may be restricted in certain jurisdictions. Any persons coming into possession of this material should seek advice for details of, and observe such restrictions (if any).

This material may have been prepared by an advisor or entity affiliated with an entity mentioned below through common control and ownership by Legg Mason, Inc. Unless otherwise noted the "\$" (dollar sign) represents U.S. Dollars.

This material is only for distribution in those countries and to those recipients listed.

All investors in the UK, professional clients and eligible counterparties in EU and EEA countries ex UK and Qualified Investors in Switzerland.

Issued and approved by Legg Mason Investments (Europe) Limited, registered office 201 Bishopsgate, London EC2M 3AB. Registered in England and Wales, Company No. 1732037. Authorized and regulated by the Financial Conduct Authority. Client Services +44 (0)207 070 7444. "

All Investors in Hong Kong and Singapore:

This material is provided by Legg Mason Asset Management Hong Kong Limited in Hong Kong and Legg Mason Asset Management Singapore Pte. Limited (Registration Number (UEN): 200007942R) in Singapore.

This material has not been reviewed by any regulatory authority in Hong Kong or Singapore.

All Investors in the People's Republic of China ("PRC"):

This material is provided by Legg Mason Asset Management Hong Kong Limited to intended recipients in the PRC. The content of this document is only for Press or the PRC investors investing in the QDII Product offered by PRC's commercial bank in accordance with the regulation of China Banking Regulatory Commission. Investors should read the offering document prior to any subscription. Please seek advice from PRC's commercial banks and/or other professional advisors, if necessary. Please note that Legg Mason and its affiliates are the Managers of the offshore funds invested by QDII Products only. Legg Mason and its affiliates are not authorised by any regulatory authority to conduct business or investment activities in China.

This material has not been reviewed by any regulatory authority in the PRC.

Distributors and existing investors in Korea and Distributors in Taiwan:

This material is provided by Legg Mason Asset Management Hong Kong Limited to eligible recipients in Korea and by Legg Mason Investments (Taiwan) Limited (Registration Number: (98) Jin Guan Tou Gu Xin Zi Di 001; Address: Suite E, 55F, Taipei 101 Tower, 7, Xin Yi Road, Section 5, Taipei 110, Taiwan, R.O.C.; Tel: (886) 2-8722 1666) in Taiwan. Legg Mason Investments (Taiwan) Limited operates and manages its business independently.

This material has not been reviewed by any regulatory authority in Korea or Taiwan

All Investors in the Americas:

This material is provided by Legg Mason Investor Services LLC, a U.S. registered Broker-Dealer, which may include Legg Mason International - Americas Offshore. Legg Mason Investor Services, LLC, Member FINRA/SIPC, and all entities mentioned are subsidiaries of Legg Mason, Inc.

All Investors in Australia:

This material is issued by Legg Mason Asset Management Australia Limited (ABN 76 004 835 839, AFSL 204827) ("Legg Mason"). The contents are proprietary and confidential and intended solely for the use of Legg Mason and the clients or prospective clients to whom it has been delivered. It is not to be reproduced or distributed to any other person except to the client's professional advisers.