

A crisis of confidence, not economics

The traditionally volatile August to October period is living up to its reputation and September's market performance may have disheartened those investors hoping for a bounce back after a dismal August. But, according to Legg Mason Capital Management, the US economy may be in better shape than stock market performance is indicating.

Based on our research, the performance of stocks has diverged sharply from corporate results, which show stability to improvement in most cases. Current US economic conditions are not deteriorating as stock prices would suggest. While not a robust recovery by any measure, US economic activity is actually accelerating. In the first quarter of 2011, real US GDP growth was 0.4%. This increased to the just-reported 1.3% in the second quarter. As of the 7th October, the Bloomberg consensus estimates for GDP was 1.8% for the third quarter and 2.2% for the fourth. Macroeconomic Advisers, the firm founded by former Fed Governor Larry Meyers, recently forecasted third-quarter GDP of 2.4%.

While the market appears priced for a post Lehman's scenario, the overall environment, especially for US companies, is vastly better than it was in 2008. US banks have been recapitalised, and households and corporations have dramatically improved their balance sheets as well. We appear to be in the early stages of a rebound in auto production. Credit card and payment processors that we speak with saw accelerating consumer spending through August. Less-than-truckload carriers, who normally sneeze before the rest of the economy catches cold, are experiencing increased demand.

Most measures of housing sector health continue to flatline, but the chasm between housing starts (around a 571,000 annual pace in August) and new household formation (estimated at roughly 1.3 million annually based on a study by the Joint Center for Housing Studies of Harvard University) means that excess inventory will inevitably be absorbed. In our view, the recovery in housing is a matter of when, not if. While the interbank liquidity measures we monitor are rising, they are a fraction of their 2008 levels and are even below the levels they reached in the middle of 2010. Today's LIBOR-OIS spread is 31 bps (the 2008 peak was 364 bps and 2010 peaked at 34bps) and the TED spread is 39 bps (2008: 460+ bps and 2010: 48 bps). So while the market seems to be pricing in an environment similar to late 2008, actual circumstances are quite a bit better.

We should know more in the coming weeks, as companies report third-quarter earnings. Warren Buffett recently said the Berkshire Hathaway businesses are all doing well except housing, which is bouncing along the bottom, although not getting worse. This has been our observation as well. So far, most companies we speak with report results that are stable. In any case, with the S&P 500 down almost 11% from its recent peak, a reasonable amount of earnings deterioration is already baked in. That does not mean that the economic and debt problems in Europe, and especially a potential spill-over into a China slowdown, are not real and concerning. They are, and the risks are receiving our vigilant attention. However, the current crisis in the US is one of confidence, not economics, at least so far. Unless the economic situation deteriorates further, the market is set for a big reversal, in our view. It may not require good news. It may only require an absence of bad news.

Batterymarch • Brandywine Global • ClearBridge Advisors • Esemplia • Global Currents • **Legg Mason Capital Management** • Legg Mason Hong Kong • Permal • Royce & Associates • Western Asset Management

IMPORTANT INFORMATION

This document, provided by Legg Mason Asset Management Singapore Pte. Limited (“Legg Mason”), is for information only and does not constitute an offer or solicitation to buy or sell any units in any fund.

The views expressed are opinions of the portfolio managers as of the date of this document and are subject to change based on market and other conditions and may differ from other portfolio managers or of the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice.

Although information has been obtained from sources that Legg Mason believes to be reliable, no guarantee can be given as to its accuracy and such information may be incomplete or condensed and may be subject to change at any time without notice.

Neither Legg Mason nor any officer or employee of Legg Mason accepts any liability whatsoever for any loss arising from any use of this document or its contents. The information in this document is confidential and proprietary and may not be used other than by the intended user. This document may not be reproduced, distributed or published without prior written permission from Legg Mason.

Legg Mason Asset Management Singapore Pte. Limited is the legal representative of Legg Mason, Inc. in Singapore. (Registration Number (UEN): 200007942R).
