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News Release

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Looking To 2019, Legg Mason Affiliates Expect to Navigate Slowing Growth, Tightening Liquidity and More Volatility…
…Yet Most See Reasons to Be Bullish on Selected Opportunities

New York, NY – December 18, 2018 – Legg Mason, Inc. (NYSE:LM) The investment affiliates of Legg Mason value their independence – offering different perspectives that set them apart from other active asset management firms. They often agree – and sometimes do not – but when each looks to the year ahead, investors can expect a wealth of insights.

Several factors came up repeatedly in their annual outlook for 2019: actions – or inaction – of the U.S. Federal Reserve (Fed); the impact of U.S.-China relations on tariffs and trade; and European Union (EU) and UK politics.

Western Asset Management, focused on fixed income, believes global growth will remain positive in 2019, as the U.S. economy moderates slightly and Europe and emerging markets (EM) regain footing. Four major global risks may challenge this view: a collapse in U.S.-China relations; the Fed overtightening; Italy's governance pulling away from EU fiscal norms; and a "hard Brexit."

The market is pricing each of these scenarios for extremely negative outcomes, but Western Asset believes there is room for less pessimism – even some optimism – regarding each factor. Claims of runaway U.S. growth also are exaggerated, which should correspond to more modest performance in 2019 (perhaps dropping to 2-2.25% GDP growth range), along with continued low inflation.

In Western's view, emerging markets (EM) is the most undervalued asset class. Extreme market pessimism pulled the entire asset class downward in 2018, despite important positives in the sector: remarkably subdued inflation and resilient sovereign and corporate balance sheets.

What's more, index yield spreads between EM debt and developed market (DM) debt are near the wide levels seen in 2008 and 2016; currency levels are 35% lower than just five years ago; and the real yield of EM debt is at a 15-year wide versus the real yield of DM debt. While the path to improving risk sentiment may well still be volatile, EM would be the biggest beneficiary of any attenuation of the global risks.
With its eye on global equity markets, ClearBridge Investments believes liquidity will be a key variable, with the potential for tighter credit conditions to impact equity prices. Recent market weakness could continue, with stocks testing a low before rallying higher.

ClearBridge believes a step down in U.S. growth is to be expected, given the front-loaded aspects of the 2017 tax cuts. However, they also believe markets have become too pessimistic about 2019 earnings growth. Interest rates will continue to climb, if at a subdued rate, while the Fed continues to shrink its balance sheet.

Yet ClearBridge also believes performance will guide equity markets: they expect strong cash flows and strong buybacks to support stocks, and quality-oriented stocks to outperform in 2019.

The year following midterm elections has historically been positive for equities, with the S&P 500 up an average of 15% in the 12 months following midterms going back to 1950. The U.S. economy has not seen the start of a recession during the third year of a presidential term in the modern era, because fiscal stimulus tends to be strongest in the middle of a presidential cycle.

Consumers will see a $60 billion boost in spending potential in 2019 from tax refunds. The divided Congress could come to a compromise that leads to higher infrastructure spending.

Brandywine Global is concerned about the limits of growth and sees Fed policymaking and U.S.-China relations as key drivers of global economic growth in 2019. Supercharged U.S. growth and countertrend dollar strength were the consequences of 2018's late-cycle stimulus. Divergence in relative growth has limits, leading Brandywine to expect U.S. and international growth rates to converge.

Like Western Asset, Brandywine would not be surprised to see a gradual deceleration in U.S. GDP growth, falling perhaps to 2-2.5% by the end of 2019. Narrow money growth has slowed, the personal savings rate remains elevated, and household credit has not picked up. Mortgage applications have been off around 20% year-on-year, new home sales have softened, auto sales have been flat-to-down for three years, and consumer confidence has softened.

Brandywine also believes inflation expectations priced into emerging market bonds are just too high relative to actual inflation rates, while expectations for the developed world are low. They expect that adjusting inflation expectations in 2019 will compress this spread.

Global equity affiliate **Martin Currie** forecasts persistent volatility and the potential for long-term upside. Higher interest rates are not going to be good news for expensive equities (especially for companies that gorged on cheap liquidity for the last decade), as they mean higher borrowing costs. As such, they expect to see volatility persisting in equity markets for some time to come.

Martin Currie believes there is risk that the global trade war that came to the fore in 2018 will worsen in 2019, bringing with it the wrong type of inflationary pressure – the regulatory-driven kind. This has the risk of ushering in a sharp slowdown to global activity, while pushing central banks towards more tightening measures – an unpleasant combination for equity markets.

Looking at Europe, uncertainty around Brexit – specifically the shape of the final 'divorce' deal – and Italian sovereign risk will both preoccupy markets. Central bank policies will also remain an important focus, with economic momentum weakening across the EU, China and the U.S.

The market is also becoming increasingly anxious about risks of a recession, which is likely to add further volatility in 2019. There is potential for investors with shorter time horizons to be spooked, but Martin Currie believes these risks create opportunities for long-term investors: specifically, to buy stocks exposed to long-term secular growth drivers at attractive valuations. The EM asset class still represents good value in terms of an international equity allocation.

To small-cap equity specialists **Royce & Associates**, a shift toward cyclical stocks may be coming.
The pullback in prices in small caps since October has been challenging, but the shift was not unexpected and could prove potentially healthy for investors. Royce has argued that the market would enter a period characterized by increased volatility, rising rates and lower overall returns – and that this would lead the market back to more historically typical return and volatility patterns.

Royce does not see the likelihood of a recession. Corporate profits are still healthy, and consumer demand and confidence remain high. Yet even with a strong U.S. economy, anomalies exist. The small-cap index has many businesses that are not making money – about 36% of Russell 2000 companies have no earnings. Year-to-date through August 31st, those non-earning small-caps had higher returns, up 23%, while those with earnings advanced only 13%.

Royce's small-cap strategies tilt toward cyclical stocks – with earnings – in sectors such as industrials, information technology, financials, consumer discretionary and materials. Over the last two years, these areas have lagged; the highest returns have come from growth-oriented industries, such as software. But recent positive earnings news for cyclical companies could potentially reverse a relative performance disadvantage that has persisted longer than expected.

Higher volatility and lower returns will result in more investors looking for companies with earnings. This should position earnings-driven active management approaches to outperform.

Clarion Partners, which specializes in real estate, is focused on the potential for an extended business cycle.

If this business cycle continues through July 2019, it will be the longest in modern U.S. history. How much longer can it run? The firm believes bull markets do not die of old age. Rather, they die from excesses that lead to economic shocks – which, if large enough, can lead to a recession.

Despite the U.S. unemployment rate standing at 3.7%, the lowest in nearly 50 years, the slow, steady expansion does not have the makings of a boom and bust cycle. It may prolong the business cycle, with no huge imbalances or signs of the economy overheating. Tax reform and increased government spending significantly strengthened corporate and household spending power. Real 2019 GDP growth will be in the 2-2.5% range, decent but a moderation from 2018.

Commercial real estate investors prefer slow and steady growth: demand for commercial space is strong, but not so robust as to spur excess lending and speculative new development. The sector remains attractive to global investors seeking income and low volatility late in this cycle.

The near-term strategy at Clarion Partners favors industrial, urban multifamily, and central business district office, with a focus on selective value-add opportunities, especially in top secondary markets and premier suburban submarkets outside the major markets.

Clarion Partners has a cautiously optimistic U.S. commercial real estate market outlook for 2019. Pro-growth policies are likely to extend the business cycle. U.S. property fundamentals should remain healthy. Same-store net operating income (SS NOI) growth remains strong at 3%, well above the long-term average. Attractive total returns will be driven by stable cap rates, solid NOI growth and accretive financing. As occupancy rates approach 90-95% in most U.S. markets, there will be opportunities to create value through disciplined, active investment strategies.

The big question for **RARE Infrastructure** is whether it may be time for a more defensive approach. Early in 2018, RARE saw we were in the late stages of the long bull market. While not calling for a recession, RARE believes it prudent to resist the urge to ride the bull right to the inevitable end and to begin moving to more defensive postures.

Since then, volatility picked up. Unlike in January, the FAANGs have not reasserted leadership and led a bounce back. This provides affirmation of a market regime change playing out in 2019.
Countering this is the strength of the U.S. economy. Main Street appears in fine fettle, even if Wall Street seems somewhat out of sorts. None of the key recession indicators are flashing red.

The trade wars are unlikely to end any time soon. “Deals” may be announced with great fanfare, but agreements on the substantive issues seem unlikely. Trade wars impact global economic growth, which will begin to impact S&P 500 earnings; there has been a sharp pickup in warnings regarding trade and the outlook for corporate profits. Monetary conditions are tightening. The sugar rush from the Trump tax cuts and fiscal stimulus will start to wear off in 2019.

All in all, this is a recipe for continued volatility, but the U.S. economy has a decent head of steam. President Trump and the Democrats could agree on infrastructure-centered fiscal stimulus. It would be premature to reduce equity exposure too drastically at this point. Increased defensive equity exposure is in order, and infrastructure stocks are a key way to achieve it.

Quantitatively-focused multi-asset manager **QS Investors** sees choppy markets ahead.
While economic fundamentals are still sound in the U.S., there are important indicators of the frail nature of the current environment. Market volatility in October and November 2018 was a stark reminder of the risks involved in equity investing, all-but-obscured by the long bull-run.

QS expects the future to look quite different from the past nine-plus years of rising equity and bond markets amid low volatility. Several key market indicators are at historically high or low levels, suggesting ample potential for mean reversion: U.S. equity market valuations continue to appear stretched and suggest low potential returns going forward; volatility in equity markets remains at historical lows; and there is a wide dispersion between the narrow segments of the market that have led the rally (U.S., China, technology and growth/momentum stocks) and the rest (international, defensive sectors and value stocks), which exhibit more attractive valuations.

Since March 2009, U.S. equities generated over 400% cumulative returns, outpacing international equities by over 200%; growth outperformed value in the U.S. by over 100%; and five U.S. stocks contributed more than 50% to S&P 500 Index returns, year-to-date. QS expects volatility to increase as central banks exit accommodative monetary policies, global growth softens, and markets process idiosyncratic events such as Brexit and China-U.S. trade tariffs.

An allocation to defensive equity strategies, providing exposure to stocks with lower price volatility, higher dividends and strong earnings/profitability, can add a differentiated return stream with potentially more attractive risk-adjusted returns than the broad equity market.

For global alternatives manager **EnTrust Permal**, the 2019 will require investors to deal with a plethora of risks.

They believe U.S. economic growth and earnings growth are going to decelerate. Fiscal stimulus is fading, and the impact of tax reform will force earnings growth back to levels more typical of an economy in the later stages of expansion. Normalization does not mean recession, but there are many downside risks: U.S.-China trade conflicts; margin compression; widening corporate credit spreads hurting borrowing costs; oil prices; and Middle Eastern and European geopolitics.

Volatility is expected to remain elevated. Equity markets will be forced to rely on dividends and earnings growth for much of their 2019 gains, since increases in stock valuations are unlikely.

Given this outlook, EnTrust Permal generally favors value over growth strategies; favors EMs over developed; expects large caps should outperform small caps; and believes quality as a factor should perform well. The environment for active management also is greatly improved.

The shift from quantitative easing to quantitative tightening will impact liquidity, lead to higher risk premiums and impact corporate performance, bringing higher dispersion in equity prices.

So, the major common themes for 2019 among Legg Mason's diverse affiliates are increasing volatility, continued if moderating U.S. economic growth, fears of U.S.-China trade conflicts, and more fiscal stimulus potentially focused on infrastructure – adding up to cautious optimism.

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