ANNUAL OUTLOOK:
THE PRICE OF OPPORTUNITY

WHAT OUR MANAGERS SEE AHEAD IN 2020

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Gradual Growth
Investors should expect global growth to advance in 2020, underpinned by the largesse of central banks. But the pace of expansion may continue to slow, with the potential for income and return somewhat muted.

Persistent Volatility
Some macro risks, such as an unruly Brexit, appear to be moderating, yet the U.S.-China trade relationship remains a major source of uncertainty. Markets remain highly sensitive to the news cycle and are likely to test investors’ patience during the year amid shifting expectations on rates, politics, and earnings.

Cautious Confidence
The challenges surrounding markets now merit caution, but selective opportunities continue to surface across asset classes for active managers with specialized expertise and disciplined processes. Looking beyond traditional asset classes, small-caps, real estate, emerging markets, infrastructure and alternatives all merit consideration heading into the new year.
Global growth prospects remain clouded by a number of interconnected risks: a sustained decline in global manufacturing activity due to ongoing global trade tensions, a more pronounced slowdown in Europe and China, the possibility of policy missteps by developed market (DM) and emerging market (EM) central banks, and newer flashpoints in Hong Kong and Saudi Arabia, with ramifications that remain unknown.

While downside risks have risen this year, we believe global growth should prove to be resilient in 2020. We remain encouraged by the ongoing strength of the consumer globally and the enormous amount of monetary stimulus supplied by both DM and EM central banks—the combined weight of these two forces should truncate downside growth risks as we move closer to 2020.

In the U.S., we’re encouraged by a recent rebound in consumer spending and a tentative improvement in manufacturing data. We see nothing in Fed policy nor in the ongoing growth rates of nominal GDP that would suggest any inflation spikes over the near- to mid-term.

For the eurozone, while there are many downside risks and some countries might be at the brink of a technical recession, we feel that the market has become too pessimistic. In addition, the European Central Bank (ECB) has restarted its asset purchase program, linking its duration explicitly to inflation outcomes.

We expect the German economy to accelerate in 2020 and a growth rebound in Italy on abating political noise. Other large eurozone countries could slow somewhat, but are likely to grow supported by accommodative monetary and fiscal policies across the continent. Risks around this baseline for 2020 are skewed to the downside; for example, if the service sector weakness in soft data becomes more pronounced and starts showing up increasingly in hard data. Other key risks next year include a disorderly Brexit, higher crude prices, and further trade escalation.

Eurozone Growth Remains the Principal Source of Global Growth Worries

Looking ahead to 2020, we expect eurozone growth to be around 1%, which reflects recent disappointments in soft data including service PMIs. While there are many downside risks and some countries might be at the brink of a technical recession, we feel that the market has become too pessimistic. In addition, the European Central Bank (ECB) has restarted its asset purchase program, linking its duration explicitly to inflation outcomes.

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China: No Quick Fix

China’s economy is slowing for both structural and cyclical reasons at a time when the global economy is softening. Although USDCNY has traded above the 7.00 level, we do not consider the bilateral exchange rate to be of great significance as Chinese policymakers have fixed the CNY via a basket of trading partner currencies. On U.S.-China trade tensions, we do not expect to see a quick permanent turnaround in the near term, as neither country appears keen to concede meaningful ground. Looking ahead, escalating tensions and uncertainty will continue to weigh on sentiment, leading to further drags on capital expenditures and consumer confidence.

Asia in general looks well poised to provide fiscal easing to address near-term cyclical shocks from trade tensions and structural headwinds from the global economy. Countries likely to increase policy accommodation include Korea, Singapore, Hong Kong and Taiwan. Yet in EM economies, the case for structural reforms, for removing more barriers to foreign investment, increasing banking system liquidity to support domestic corporates and for infrastructure investment remains critical. Recent data out of Thailand and even the Philippines suggest economic growth continues to decelerate, driven by a slowdown in external demand and with domestic growth highly dependent on fiscal impulse and execution. Inflation (or the lack thereof) supports the base case for more monetary support even as central banks in Asia are increasingly aware that the challenges lie not just in policy rates but in still-weak transmission channels. Price pressures are subdued across Asia, with structural factors such as informal employment and still-strong demographic growth in EM Asia keeping wages low.

Against this backdrop, Asia local currency bonds in selected markets such as China, India and Indonesia could outperform broader EM this coming year. Asian currencies and local bond yields may benefit from the Fed dovish pivot amid subdued inflationary pressures. An emphasis on higher carry currencies could help maintain a yield buffer/advantage, noting that the yield spread between the JPMorgan Government Bond Index (Emerging Markets Asia) vs. the Citi World Government Bond Index stands at over 250 bps (as at 30 September 2019). In addition, Asian USD bonds, especially issues by Asian investment-grade corporates, crossover credits and Asia sovereigns/quasi-sovereign entities can be key considerations for investors looking for a diversifier and yield enhancer.

Australia: Avoiding Stall Speed, For Now

Growth in Australia has slowed in line with other DMs and we now expect growth of 2.0%-2.5% in 2019. Although a reluctant cutter, the Reserve Bank of Australia (RBA) reduced rates three times since June 2019 after almost three years on the sidelines and has maintained an explicit easing bias. The market has brought forward expectations for the next rate cut, perceiving a greater likelihood of one more cut before year-end and the possibility of further easing in 2020.

Additionally, we now expect growth of 2.0%-2.5% in 2019 as there are indications that the housing market has bottomed. Although very strong, jobs growth has failed to keep pace with record labor force participation over the past year, resulting in a small rise in the unemployment rate, one of the key indicators the Reserve Bank of Australia (RBA) has explicitly targeted in its rate-setting deliberations. This would point to at least another cut in the near term.
GLOBAL EQUITIES

CONSUMERS HOLD THE KEY

Equity markets may be volatile, but solid consumer spending should help avert a U.S. recession.

U.S. Equities: Volatility but Growth

The S&P 500 Index made new all-time highs in 2019, as on-and-off trade tensions with China eased, the Federal Reserve cut interest rates three times and corporate earnings held up better than anticipated. Strong market performance came against a backdrop of weakening economic activity, reflected in the overall signal for the ClearBridge Recession Risk Dashboard turning yellow in June, indicating caution.

As we enter 2020, both the U.S. and global economies are clearly slowing; the key question is whether we are on the cusp of a recession or a late-cycle slowdown. The economy typically sees an inflection point six to nine months after our Dashboard turns yellow, so we should have confirmation by early next year of the severity of the current soft patch.

Our base case is for a slowdown within an ongoing economic expansion. While we expect the contraction of the manufacturing sector to marginally worsen as the ongoing trade war hurts business confidence and slows capex, the consumer side of the economy should remain strong enough to avert recession. The labor market and wage growth are healthy, which should underpin consumer spending, while the Fed has joined with central banks around the world in ramping up monetary accommodation.

The potential strength of this support is reflected by all four consumer indicators in the dashboard flashing green, indicating expansion.

- After slowing in line with rising mortgage rates, housing permit growth has resumed since the Fed shifted its monetary policy stance and mortgage rates eased.
- A strong October jobs print and upward revisions for the prior two months are consistent with jobless claims continuing to trend around 50-year lows – while job sentiment has improved after a mid-year decline, with job openings outnumbering unemployed workers by a significant margin.
- The wildcard among our consumer indicators is retail sales, which posted a surprise decline in September ahead of robust October jobs data.
- Monthly sales numbers can be noisy, but a drop in spending – which accounts for 70% of the U.S. economy – would be a major concern.

While volatility will likely remain elevated, a market drawdown next year is not imminent. In fact, over the last 19 U.S. presidential election cycles, stocks have suffered losses just twice in the 12 months leading up to election day, delivering an average return of 8%. Equities have also tended to do well in periods following a yield curve inversion, especially if no recession occurs, rising 13.5% on average in the subsequent 12 months. The 2-year/10-year U.S. Treasury yield curve inverted in August, suggesting that stocks could climb through most of next year.

Cyclicals have gotten a bid from the Fed easing, but this rally could be short-lived; we do not believe the manufacturing side of the economy is out of the woods yet. For example, corporate credit spreads at the lowest quality ratings, which encompass energy, industrials and some retail names, are at their widest levels in over a year.

Instead, the likelihood of continued volatility in 2020 steers us to high-quality growth companies with strong moats around their businesses and more defensive areas of the market that have tended to hold up well during turbulent periods. Consumer staples and utilities should continue to lead unless we see a clear resolution of the trade war and improvement in global growth.

One of the benefits of these stocks is dividends, particularly given the low yields on bonds in general. It’s worth noting that through the third quarter of 2019, 42% of S&P 500 stocks had a higher dividend yield than the 30-year U.S. Treasury bond.
Dividend Stocks Look Attractive
% of S&P 500 stocks with Dividend Yields > 30-year Treasury yield

International Equities Could Surpass Low Expectations

Economic sentiment in most international regions worsened over the course of 2019, which we believe sets a low bar for non-U.S. equities heading into 2020. Manufacturing data continued to weaken, yet consumers held up relatively well. We see reasons for optimism that are underpinned by policy moves. The European Central Bank has resumed a measured program of quantitative easing, and the U.S. Federal Reserve is lowering interest rates while China and Japan continue to provide ample liquidity. In past cycles, increasing money supply has supported stock values after a several-month lag, with the manufacturing sector picking up soon after. If we do not see a hardening of the U.S.-China trade tensions, this could be the case again.

Europe: Valuations in the United Kingdom and Europe are attractive, particularly compared with U.S. equities (as indicated in the chart). European stocks are at 50-year lows vs the U.S., which has represented a good entry point the last two times performance dispersions became this extreme. Near-term risks in Italy are contained for now with a new moderate government in place. Fiscal stimulus is being discussed within the EU, which would be a clear positive. Brexit remains a wild card with Prime Minister Boris Johnson calling for December elections after his initial Brexit deal was rejected by Parliament and the EU granted an extension for a deal until the end of January.

European Equities Are Historically Cheap
Relative performance (in basis points) between European and U.S. stocks

Asia: Japan, China and emerging markets are very dependent on progress in trade talks. A positive trade resolution should cause the U.S. dollar to weaken, which would most benefit emerging markets. How Beijing deals with the protests in Hong Kong and the ongoing trade standoff will provide important signs of where the global economy and equity markets are headed. Geopolitical risks are a constant but can represent opportunity for investors.
GLOBAL FIXED INCOME
GROWTH IN THE SLOW LANE

In addition to reduced trade tensions between the U.S. and China, there are several points of support for the world economy.

2020: Making Progress, But Still Stuck in the Slow Lane

As we prepare for 2020, some market participants and investors remain concerned about whether a downturn in U.S. economic conditions could precipitate a global recession. Rather than making a recession call, we instead prefer to highlight the factors that should support the global economy in 2020 and turn the two-year slowdown into a period of slow but sustainable growth. These supportive factors include improving consumer fundamentals, improving economic indicators from emerging markets, impending reform, and the global backdrop of low inflation that has ushered in a wave of global monetary easing.

Global Business Conditions Should Take Cues from Consumers

Looking at how 2019 unfolded, it’s easy to understand why optimism gave way to pessimism. U.S.-China trade tensions escalated while the Federal Reserve (Fed) neglected to modify policy quickly and expand it broadly enough to offset the domestic consequences of this dispute, which then fed into the global economy. These factors had a profound impact on global business conditions, which took a significant hit in 2019. Both investment spending and business sentiment declined, as shown below:

However, the chart also shows that consumers have been globally optimistic, including in the U.S. In 2020, we believe consumer optimism and strong household fundamentals could lead business confidence higher. In particular, the U.S. consumer could determine whether the domestic economy emerged from a mid-cycle slowdown or is headed toward a recession that could spread to the rest of the world. We will be monitoring consumer sentiment and expectations very closely in the U.S. and beyond, to determine whether that continues to buoy household spending, and eventually feed into the business cycle by encouraging companies to increase capital expenditures.

Positive Signs Emerge in Asia

The positive impact that global consumers could have on business conditions has become evident in Asian export activity. Following one of its deepest troughs at the beginning of 2019, Asian export volume rebounded significantly over the past few months despite headwinds from the trade dispute and the resulting drag on China’s economic activity. Even countries with significant ties to the Chinese economy—such as
Taiwan, Singapore, and South Korea—took part in this recovery, underscoring the role of consumer demand in the global economy, and how governments are taking steps to preserve household health.

**More Countries Are Expected to Implement Reform**

Australia is another example of an economy that has significant ties to China. In 2020, we expect to see more countries follow Australia’s lead, by taking a multi-faceted approach to stimulus as a way to buffer the lingering effects of weak economic activity from the prior year. In Australia’s case, the governing Liberal Party has pledged to pursue a pro-growth agenda while the Reserve Bank of Australia eases. Although Australia runs a modest budget surplus, it has some slack to implement reform and fiscal stimulus intended to support households, improve infrastructure, and invest in potentially competitive sectors. Therefore, we expect countries with relatively stronger fiscal and external positions to pursue fiscal stimulus in 2020. Since the efficacy of easier monetary policy from developed market central banks is expected to fade, generating a growth impulse from government reform and fiscal stimulus should become increasingly important in 2020 and beyond.

**Global Monetary Easing Should Register in the Economy**

Most central banks around the world joined the G3 in 2019 by easing monetary conditions, a trend that should persist in 2020. For its part, the Federal Reserve (Fed) course-corrected three times to address global headwinds and improve domestic business conditions. The effects of these coordinated easing efforts will continue to take time to register in the global economy as shown in the chart below:

![Global Manufacturing PMI and Monetary Policy Stimulus, Jan 1997 through October 2019](chart)

The tailwinds of easier monetary conditions should transmit into global economic activity in 2020 and eventually push global manufacturing Purchasing Manager Indices (PMIs) higher. While the chart above shows global PMIs hovering at that crucial “50” mark, emerging market manufacturing and services PMIs have remained expansionary in 2019, helping that broader metric stay in neutral territory. We expect emerging market PMIs will remain strong in 2020 and lend support to developed markets. Similarly, strength from the services sector of the global economy could also offset the slowdown in manufacturing.

This emerging market strength should come from lower policy rates—global short-term rates on a weighted GDP basis should stay around 2% in 2020—targeted reform, and improved external balances, including their current accounts.
Developed market manufacturing PMIs contracted in 2019, likely dragged down by Germany and the broader eurozone economy, which have been collateral damage in the U.S.-China trade dispute. The regional bloc has exhausted monetary policy and fiscal stimulus is needed. We have previously invoked German and European Commission officials to leverage their twin surpluses to stimulate the regional economy. However, it will be an incredibly high hurdle to convince more member countries and European Commission officials to increase spending to address flagging growth in 2020.

A More Constructive Growth Outlook in 2020

A weak global macro pulse has started to support the world economy. For example, consumer confidence remains high, Asian export volume rebounds, emerging market PMIs remain expansionary, central banks ease in concert, and government budgets account for stimulus. While these factors should bode well for the global economy, the onus will nevertheless be on the U.S. and China to rein in those risk factors that precipitated the broad-based slowdown that started in 2018. We will need to see credible progress in terms of a trade deal, and sound policymaking from the Fed and Chinese authorities. If these factors were to crystallize, we expect that cyclical inflation pressures would remain controlled, U.S. economic growth would level off around 2% and Chinese economic growth would rebound. The biggest risks to this outlook include more policy inaction from the Fed and Chinese authorities, or the onslaught of political volatility related to the U.S. election cycle.

Investment Implications

The slump in Chinese economic activity significantly contributed to global malaise in 2019, as the country attempted to structurally change its economy amidst a trade dispute without implementing enough stimulus. Later in 2020, Chinese policymakers may pivot away from stimulus and refocus on generating organic growth. Meanwhile, emerging markets have run a combination of prescriptive policies to preserve industrial activity and consumer confidence. In aggregate, emerging markets are running an approximate 1% current account surplus on a GDP-weighted basis in spite of a challenging macro backdrop. So long as emerging market central banks continue easing, we expect these improvements to extend into 2020. As economic activity outside the U.S. picks up in 2020, the relative growth differential should narrow and allow the U.S. dollar to weaken more broadly.
REAL ESTATE
CAUTIOUS OPTIMISM AMID CHANGE

Demand for tech-friendly spaces and multi-family dwellings should help keep commercial real estate on course in 2020.

Heading into its twelfth year, U.S. economic expansion has maintained solid momentum. A strong macro environment and healthy property fundamentals have supported U.S. privately-held commercial real estate investment performance. The ongoing rise in occupancies, rents and asset values has continued to offer attractive risk-adjusted returns.

Institutional investor allocations to the asset class have continued to increase. Average target allocations to the real estate asset class increased 10 basis points (bps) to 10.5% in 2019, up approximately 160 bps since 2013.¹ Investment sales momentum has been very strong year-to-date after a near peak level in 2018, and we expect a strong year ahead in 2020 given the resilience of the U.S. expansion. U.S. transaction volume reached $579 billion, the highest level so far in this expansion (just below the 2007 peak).²

Figure 1: Real Estate as a % of Institutional Investor Current & Target Allocations

Source: Preqin. November 2019. Note: Based on over 8,000 global institutional investors in database. Past performance is no guarantee of future results. Indexes are unmanaged and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Most key demand indicators have remained positive; however, growth has varied significantly by region, industry, and property sector. Going into 2020, influential investment themes include the omni-channel consumer, affordable housing, generational demographics, tech clusters, and functional obsolescence.

As such, Clarion Partners sees the most compelling ongoing opportunities in industrial and multifamily, as well as a few alternative or specialty niche sectors – such as medical office, life sciences/labs, self-storage, senior housing, student housing, and entertainment/sports.

Going forward, key issues to watch are:

- E-commerce climbing to almost 50% of all GAFO retail sales;³
- The continued and rapid rise in housing prices;
- Faster job growth in tech-influenced U.S. cities (e.g. Seattle, Austin, the San Francisco Bay area, and Boston);
- The shift by both aging Millennials and Baby Boomers to both low-tax and less costly areas (e.g. the suburbs and Texas, Florida, Arizona, and North/South Carolina);
- Higher construction costs largely due to labor shortages, which have impacted the pace of new development.

Clarion Partners’ outlook for 2020 is cautiously optimistic. U.S. consumer spending remains strong, buoyed by a tight labor market and record-high stock market. The Federal Reserve is on an easing path, having lowered interest rates three times in 2019 and injected $250 billion of liquidity into the repo market. Low interest rates have led to historically high asset values and ongoing appreciation (excluding retail) at a time when top markets abound with capital. We believe that U.S. commercial real estate will continue to be a source of steady current income over the next year.

² Real Capital Analytics. Q3 2019.

Demand for tech-friendly spaces and multi-family dwellings should help keep commercial real estate on course in 2020.
GLOBAL EQUITIES
SHIFTING THE GLOBAL BALANCE

Emerging markets could be poised to replace the U.S. as the main engine of global growth as current trends normalize.

In the U.S., economic activity has been waning, principally caused by trade tensions with China. There are green shoots in the negotiations, but as the tensions have escalated and tariffs have affected supply chains and product price inflation, the economy has slid closer to recession. It is likely that the Federal Reserve will continue to provide liquidity to the U.S. dollar, funding markets and cutting interest rates further to stimulate activity which should boost the economy in 2020. It is also possible that President Trump might seek a large tax cut for middle-income Americans to garner support for his re-election. This would underpin equity markets, with consumer sectors set to benefit the most.

The UK is now looking very likely to exit the European Union at the end of January with a withdrawal deal in place. Brexit certainty should bring with it a relief surge of economic activity, leading to European macroeconomic indicators bottoming out and rebounding particularly the manufacturing PMIs. Sectors such as autos, insurance and capital goods could do well as a result. We should also see some better performance from those companies with a UK domestic focus as many are trading at appealing valuations versus their own history. But we do need to see a resurgence in capital investment in Europe to ensure that productivity and corporate earnings rebound to drive stocks higher over the longer term in our view. Some fiscal stimulus may be required by countries such as Germany, which currently find themselves bogged down in a technical recession.

We expect emerging economies to see stronger domestic growth in 2020 and once more become the main engine of global growth. Yet there are risks in the form of international trade disputes, public protests and uncertainty within post-Brexit Europe that could leave investors seeking refuge in safer assets. We believe many emerging market economies will see an uptick in growth in 2020. In some cases, such as Russia, South Africa and Turkey this represents a rebound after years of subdued growth. In most emerging economies, however, growth has remained intact and should expand further on the back of widespread interest rate cuts made throughout 2019.

Europe

European economies have been struggling with demand weakness spreading from the automotive industry into wider manufacturing. The magnitude of the PMI declines now mirrors 2001-02 and 2014-15, with the malaise spreading to Asia and North America. Producers, distributors and purchasers have been reducing inventories for some time which has helped depress growth. As this ends, it should lead to stabilization in the first half of 2020 and hopefully improvement after the summer. It is important that the synchronized global slowdown is brief, otherwise we will need to see emergency interest rate cuts to offset a global recession under which circumstances equities will suffer.

The UK general election may help break the Brexit deadlock and therefore create a material investment opportunity. This relies on the composition of the next government: for equities, the best result is a decent Conservative majority. Under this scenario we would expect UK domestic stocks to materially outperform as the new government takes fiscal action to stimulate the economy, corporate investment levels improve as uncertainty is removed and risk premiums fall. The more complex the general election result, the more likely that Brexit will be delayed, Sterling will weaken, and the FTSE will materially outperform domestic equities.

2019, like 2017, has seen unusually low market volatility. With central banks coming to an end of their rate cutting, we are likely to see a return to higher levels of volatility. In recent years, equities have been boosted by slower economic growth due...
to the central bank dovishness; however, a global recession would likely see equities materially de-rate. It would be hard to have accelerating earnings forecasts when GDP growth and inflation are likely to be below 1%.

Asia
In Asia we view the bottoming of earnings expectations, coinciding with basing-out of global PMI data, as near-term market catalysts. Valuations, especially asset-based metrics, are supportive. The ratio of earnings upgrades to downgrades in Asia has been exhibiting signs of stabilisation and may have already bottomed – any modest improvement in the underlying business environment will filter swiftly into this ratio and drive stock prices higher. Several factors are causing this stabilisation and could act as potential catalysts for more sustained improvement:

- Coordinated monetary policy relaxation within the region and globally, combined with increasing adoption of more supportive fiscal policy measures.
- The U.S. dollar has strengthened steadily since the end of Q1 2018, amid a deceleration of global economic growth. This is typically not supportive of Asian stock prices, so a dissipation of the dollar appreciation impetus would likely be a positive for Asian stocks.
- Stable or lower energy prices. Strong energy prices are a tax on growth for Asia given that most countries in the region are net importers.
- Easing of trade tensions between the U.S. and China – tensions between these two countries may be a persistent feature for many years to come; however, a workable trade agreement, including a de-escalation of the tariff regime, would be an obvious positive for the business environment.

Emerging Markets
Throughout 2019, the direction of emerging markets was dictated by each new development in the U.S.-China trade negotiations. No one has given up hope that good sense will prevail, but with only limited resolution to date, trade concerns will remain front of mind for investors in 2020. Against this backdrop, we expect emerging market investors will look to secular growth sectors such as health care, education, cloud computing and clean energy as sources of relative strength within the asset class.

At a regional level, China’s policy objectives in recent years have been as much focused on the sustainability and quality of economic output as they have been the absolute level of growth. We expect this trend to continue in 2020 and would not be surprised to see growth slip below 6%. This still leaves China as one of the highest-growth economies and we believe Chinese equities will continue to attract increasing interest from global investors. Of particular note, China is implementing corporate bankruptcy policies that are very recognizable to Western investors.

Meanwhile, India is introducing far-reaching labor reform policies; this is a necessary condition for India’s emergence as a regional manufacturing powerhouse. Enactment of these policies is not guaranteed, but they could be attractive for global manufacturers while also reducing costs for local manufacturers and creating the right incentives for smaller companies to scale up. All of this would enable more workers to enter the formal economy.

Elsewhere, 2020 looks set to be a challenging year for politicians in Latin America as populist demands and ideological divisions are likely to set a tricky path for progress. The incoming government in Argentina is stepping into the midst of a currency crisis and facing demands for wealth distribution from a disillusioned populace. Dissatisfaction with the level of wealth distribution was also behind recent riots.
in Chile and has forced the government to back down on proposed price hikes in public services. On a more positive note, Brazil looks well placed to drive through pension reform, a keystone in building future confidence in the country’s public finances.

**Australia**

The Australian economy retains viable options to boost growth given low government debt and a fiscal surplus. Fiscal stimulus is likely to be far more effective than monetary easing in boosting activity and incomes. Economic growth is benefiting from the low Australian dollar, strong commodity prices and strong population and employment growth; however, disposable income growth is stubbornly low because of the high tax take.

The current uncertain global and political environment has caused weaker recent growth data. High household debt, restrictive household lending, falling investment income and falling iron ore prices pose tail risks. Government tax cuts, the recent interest rate cuts by the Reserve Bank of Australia (RBA) and easing of residential housing credit restrictions are positive for the economic outlook. While index equity valuation levels are fair to high, this hides a large divergence between premiums for defensive/quality/growth assets versus cyclical/value assets. This dispersion has parallels to past turning points such as the global financial crisis and the tech bubble.
LOOKING BEYOND THE U.S.

Conditions that have favored the U.S. are eroding, while risks that have held back the rest of the world may be dissipating.

Central banks have, once again, begun a synchronized easing cycle. There is a near-unified commitment by central banks globally to keep rates low – and in many cases negative – for the foreseeable future. That was largely in response to a deteriorating growth outlook in the U.S., led by increased trade tensions in May. Chinese stimulus policies, up until recently, had been too measured to be effective in supporting global growth.

As a result, U.S. assets outperformed; equities and bonds performed well, and the U.S. dollar was resilient relative to other currencies especially in emerging markets. While global growth is undoubtedly slowing and the IMF recently downgraded growth to 3% for 2019, the lowest level since the Global Financial Crisis (GFC), that does not necessarily mean a recession is imminent.

In Q3 2019, China adopted broader stimulus measures, both fiscal and monetary, which combined with accommodative monetary policy and easier financial conditions globally may support renewed economic momentum. Additionally, the two primary tail risk events, Brexit and U.S.-China tensions, are potentially dissipating and will soon be either behind us or diminished in impact.

As a result, “U.S. exceptionalism” may wane. The environment would become negative for the U.S. dollar. It is possible, with improved economic momentum, to see a cyclical recovery and reflation theme take hold. Emerging market assets may finally start to outperform, and EM currencies would outperform more defensive developed market currencies.

Additionally, cyclical and value-driven equities would outperform. This is an out-of-consensus view that would be supported by positioning as it is under-owned in investors’ portfolios that have been focused on growth and low volatility, defensive sectors recently. Early September 2019 hinted at how powerful a reversal in long-held positioning could be on certain segments in the market.

Other risks, primarily political in nature, also support ROW (i.e. rest of world) vs. the U.S. The impeachment fight could lead to volatility in financial markets and the 2020 election cycle will really heat up and the potential for left-leaning candidates to take the Democratic nomination could further pressure markets. Being able to capitalize on volatility in 2020 will be increasingly important to navigate uncertain political, economic and market outcomes.

Growth vs. Value: Growth of $100

Source: Bloomberg as of Sept. 30, 2019. Past performance is no guarantee of future results. Indexes are unmanaged and not available for direct investment. Index returns do not include fees or sales changes. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. Growth is represented by the S&P 500 Growth Index. Value is represented by the S&P 500 Value Index.
Looking ahead to 2020, we see three favorable factors in place for small-cap stocks: a slow economy, an accommodative Fed, and the calendar, all of which add up to positive prospects for this asset class.

That conviction reflects our recent research into what had happened historically when market, monetary, and seasonal conditions were similar to what we have in the U.S. today. This research uncovered some interesting historical patterns that offer a sizable measure of encouragement to small-cap investors now.

When economic, monetary, and market conditions have looked similar to today’s, small-caps have enjoyed subsequent returns nearly twice their historical average while avoiding losses the vast majority of the time. This three-ingredient cocktail is near-term weak economic growth, an accommodative Fed, and positive seasonality.

Most investors are aware that small-caps are more subject to cyclicality than their large-cap siblings and that small-caps typically do well when the economy is expanding. However, many investors may not be aware that the weaker the current economy, the stronger subsequent small-cap returns tend to be.

Our analysis began by taking an investment start date during months when the ISM Manufacturing Index was in the bottom 25% of its historical readings—that is, less than 49.3—since 1978. From those low points, the subsequent average 12-month return for the Russell 2000 Index was 21.4% compared with 12.8% for all 12-month periods since the small-cap index’s 1978 inception.

Most investors also know that an accommodative Fed has been good for equity returns regardless of cap size. If we add environments when the Fed Funds rate was lower than it was 12 months prior with those periods of low ISM Manufacturing Index readings, the subsequent small-cap results were even stronger, with an average subsequent 12-month return under these dual conditions of 24.3%.

Conditions today are similar to past periods that led up to solid gains for the asset class.

Steve Lipper, Senior Investment Strategist

Small-Cap Results in Two Scenarios vs. Long-Term Rolling Average

Russell 2000 Monthly Rolling 1-Year Returns by Starting ISM Level (%), From 12/31/78 through 9/30/19

<table>
<thead>
<tr>
<th>ISM Index Level</th>
<th>1-Year Return</th>
</tr>
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<tbody>
<tr>
<td>&lt;43.9</td>
<td>21.4%</td>
</tr>
<tr>
<td>&lt;49.3 + Fed Funds Rate Lower YOY</td>
<td>24.3%</td>
</tr>
</tbody>
</table>

Source: FactSet as of 9/30/19. Past performance is no guarantee of future results. Indexes are unmanaged and not available for direct investment. Index returns do not include fees or sales changes. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

The percentage of periods in which investors avoided a loss in these environments was also striking—and are especially relevant for cautious investors concerned about preserving capital and avoiding losses. In periods with both low economic readings and an accommodative Fed, small-cap returns were positive in 82% of all one-year periods, 91% of two-year periods, and 99% of three-year periods.
The final component to this bright outlook for small-cap performance is seasonality. Across the globe, equities as a whole have enjoyed higher historical median returns from October through March than they have from April through September. Explanations vary as to the cause of this pattern, but regardless of the reasons, we think it’s important that investors know about it. For the Russell 2000, the historical median return for the six-month period from October through April was 8.9%, while it was only 4.4% for the April through September period.
MULTI-ASSET INVESTING
UNCERTAINTY ON THE HORIZON

Late-cycle market concerns make turbulence more likely in US equities – but the underlying issues may generate opportunity elsewhere.

Despite significant bouts of volatility, equity markets have continued to march on, surpassing record highs several times in 2019. At end of the October 2019, U.S. equities had returned over 450% since the March 2009 Global Financial Crisis bottom. Investor optimism has been supported by three successive interest rate cuts by the U.S. Federal Reserve and, more generally, hints of a return to expansionary monetary policies by central banks across the globe, coupled with the promise of a U.S.-China trade agreement.

However, uncertainty lurks on the horizon. Recurrent tensions in U.S.-China relations, lack of clarity in the implementation of Brexit, soft economic data and geopolitical tensions in the Middle East and Hong Kong, among others, have heightened investor fears and sparked volatility in equity markets. Furthermore, a number of warning signals have begun to flare, including the inversion of the 2- and 10-year segment of the U.S. yield curve in August and expectations of lower equity market returns as we enter the latter stages of this protracted expansion.

While an inversion in the yield curve is typically associated with recession, it is key to note that historically, an inversion in the U.S. yield curve has preceded a recession by an average of 14 months and in multiple cases the period between one (the inversion of the yield curve) and the other (recession) has been closer to two years.

Time between U.S. Yield Curve Inversion (2 years - 10 years) and Recession

Source: Bloomberg. Past performance is no guarantee of future results. Indexes are unmanaged and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. Short-term dated bond yield is represented by the 2-year yield index and long-term yield represented by the 10-year bond yield. Time to recession is calculated as the time between the final sustained inversion of the yield curve prior to the recession, and the onset of recession.
Additionally, as shown below, it is worth noting that U.S. equity market returns have been exceptionally robust prior to a peak in equity markets. Against this backdrop, investors confront two seemingly conflicting objectives; how to maintain equity market participation (for capital growth), while limiting vulnerability to a late-cycle correction or negative market shock (for capital preservation). Repositioning portfolios away from cyclical, high-beta stocks, and diversifying into defensively oriented stocks that pay sustainable dividends is a compelling strategy.

Defensively oriented stocks can lower overall portfolio volatility and dampen drawdowns while allowing for equity market participation. Dividends typically become a larger and more stable component of total return in low return environments and lower volatility profiles may mitigate drawdowns during periods of market turbulence. Defensive equity income strategies may help investors prepare their equity allocations for a turbulent, yet potentially profitable 2020.

**Historically Robust Equity Returns Pre-Peak Average Total Equity Return 1945-2018 (%)**

![Chart showing historical equity returns](chart.png)

Source: FactSet, Robert Shiller, S&P 500 Index, JP Morgan Asset Management. Chart is based on return data from 11 bear markets since 1945. A bear market is defined as a decline of 20% or more in the S&P 500 Index. Monthly total return data from 1945-1970 is from the S&P Shiller Composite Index. From 1970 to present, return data is from Standard & Poor’s. Past performance is no guarantee of future results. Indexes are unmanaged and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.
A renewed focus on projects related to sustainability and climate change bodes well for infrastructure stocks, despite market pessimism about growth.

2019 has seen a continuation of the trend of decelerating global growth, but we believe this has likely troughed for key economies – think of it as a late-cycle pause rather than a slide into recession. Inflation was missing in action in 2019, and we see no signs of a breakout anytime soon – which should result in bond yields being lower for longer. During 2019 RARE reduced its long-term bond yield forecasts; we feel there is still a dispersion of market views on this topic, but participants are trending toward a lower yield environment.

Central banks continue to move to the accommodative end of the spectrum, and we see that trend continuing into 2020, anchoring yields at the lower end of recent trading ranges. We have seen a steady decline in the markets’ expectations for where bond yields will track over time.

### Market Forecast of 10-year U.S. Treasury Yield in 2 Years

Source: Bloomberg. Past performance is no guarantee of future results. Indexes are unmanaged and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

This could lead to a further expansion of earnings multiples for equities as the market factors in a lower cost of capital in the long term.

There is now general acceptance that monetary policy has become less effective, and that central banks don’t have the levers to offset a large downturn. Negative interest rates and QE are not the silver bullet to offset slower growth and virtually absent productivity improvements (jobs growth isn’t resulting in quality-of-life improvements anymore). However, fiscal stimulus has been slow and small in contrast to the slowdown that we’ve seen in global growth (Chinese stimulus, in particular, has been lackluster). We believe this has underpinned the global social upheaval that has been more prevalent in 2019 and will provide the backdrop for potential changes in the political landscape in 2020.

Political uncertainty and the shift toward nationalistic policies and approaches have created uncertainty for corporates and delayed investment decisions. Infrastructure has been spared this theme as regulators continue to approve projects driving near-record asset base growth and giving certainty to future earnings growth across the sector.

### Market perspective and infrastructure positioning

We are at the latter stages of the economic and market cycle. However, the market has been too pessimistic for growth for 2020 (particularly in the U.S. where in late 2019 we estimate that consensus had a 40% chance of a 2020 recession priced in) leading to a cycling toward growth and value from defensive stocks. We expect this to continue into at least mid-2020. However, we recognize the latter stages of a market cycle are characterized by periods of market volatility, and we have certainly seen that in 2018 and 2019.

The challenges to this upbeat thesis may come from:

- Underlying macroeconomic data not recovering as quickly as the market expects and hence pressure on earnings growth expectations (for example, in late 2019 earnings growth of 10% for 2020 in Europe seemed optimistic)
- Continued sensitivity around FX, with the eurozone and China both needing a lower currency, but with weaker countries and EMs threatened by a higher U.S. dollar. Currency wars will likely continue ad infinitum
2020 will likely see increasing pressure on public policy from a range different, but connected directions. Central banks will want fiscal stimulus for economies, climate change activists will continue to pressure for change, and populist groups will pressure for governments to ease cost of living pressures and begin to address wealth gaps. The direction and evolution of public policy will have critical implications for markets in 2020.

The importance of earnings growth and confidence that companies will not disappoint continues to support higher multiples in the infrastructure sector, which are now at the high end of the relatively tight trading range since the global financial crisis. Current multiples appear reasonable given confidence in the underlying growth in asset bases driving growth in earnings, cash flows and dividends across the sector.

Key drivers for infrastructure in 2020

We have seen a broader global acceptance of ESG principals in investing, with investors actively adjusting positions to take account of this. We believe the market has been too focused on the “E”, with not enough focus on the “S”:

- This is creating opportunities where companies operating “dirty” infrastructure are out of favor. For most of these companies, regulators approved the original expenditure and building of, for example, coal-fired generation, and will continue to provide appropriate returns on that investment
- An upcoming challenge is the pressure placed on household bills from the speed of changing from fossil fuels to renewables

Infrastructure will likely continue to be in the headlines for all the right (and wrong) reasons. Global initiatives to reduce carbon emissions are resulting in local actions to support the continued development of renewable energy and drive toward greater electrification in the future. Governments are setting targets for renewable-energy-sourced electricity (EU 32% by 2030, California 60% by 2030, Virginia 0% carbon by 2050) and the Bloomberg New Energy Finance researchers expect 80% of new capacity growth through 2050 will come from renewables.

Meanwhile, significant capital is being spent to mitigate the effects of climate change and adapt networks and infrastructure to cope with more volatile climatic events (such as ice storms, wildfires), increase the efficiency of infrastructure (development of electricity storage) and reduce wastage (leaking pipes in water networks). This is driving near-record rate base growth across the sector.

We expect infrastructure to be the centerpiece of several governments’ desires to stimulate their economies with the building of infrastructure utilizing local labor, local materials and improving the efficiency of local economies. The U.S. election campaign will likely see “green” infrastructure programs gain momentum.
Forecasts are inherently limited and should not be relied upon as indicators of actual or future performance.

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Yields represent past performance and there is no guarantee they will continue to be paid.

Active management does not ensure gains or protect against market declines.

Dividends represent past performance and there is no guarantee they will continue to be paid.

Investments in small-cap and mid-cap companies involve a higher degree of risk and volatility than investments in larger, more established companies.

Investment in real estate entails significant risks and is suitable only for certain investors as part of an overall diversified investment strategy and only for investors able to withstand a total loss of investment.

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

U.S. Treasuries are direct debt obligations issued and backed by the “full faith and credit” of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity. Unlike U.S. Treasury securities, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the U.S. government. Even when the U.S. government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.

**Definitions:**

“Brexit” is a shorthand term referring to the UK vote to exit the European Union.

“USD” refers to the U.S. dollar, the national currency of the United States.

FX, or foreign exchange, is a reference to exchange rates among currencies.

GAFO, or General Merchandise, Apparel and Accessories, Furniture and Other Sales (retail sales categories) represents sales at stores that sell merchandise normally sold in department stores.

Research and development (R&D) refers to corporate activity intended to create and deploy new technologies, products, and services.

G3 refers to the world’s top three developed economies: US, Europe and Japan.

U.S., or American exceptionalism refers to the idea that the history of the United States is inherently different from those of other nations and has conferred special advantages in its historical development.

The Federal Reserve Board (“Fed”) is responsible for the formulation of U.S. policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

The federal funds rate (fed funds rate, fed funds target rate or intended federal funds rate) is a target interest rate that is set by the FOMC for implementing U.S. monetary policies. It is the interest rate that banks with excess reserves at a U.S. Federal Reserve district bank charge other banks that need overnight loans.

The European Union (EU) is an economic and political union established in 1993 by members of the European Community. The EU now comprises 28 countries after its expansion to include numerous Central and Eastern European nations.

The European Central Bank (ECB) is responsible for the monetary system of the European Union (EU) and the euro currency.
The Reserve **Bank of Australia (RBA)** is the central bank of Australia.

The **International Monetary Fund (IMF)** is an international organization of various member countries, established to promote international monetary cooperation, exchange stability, and orderly exchange arrangements.

**UN Principles for Responsible Investment (PRI)** are a set of six principles that provide a global standard for responsible investing as it relates to **environmental, social and corporate governance (ESG)** factors.

**Quantitative easing (QE)** refers to a monetary policy implemented by a central bank in which it increases the excess reserves of the banking system through the direct purchase of debt securities.

The **repo market** refers to the market for short-term borrowing for dealers in government securities. The dealer sells the government securities to investors, usually on an overnight basis, and buys them back the following day.

**Emerging markets (EM)** are nations with social or business activity in the process of rapid growth and industrialization. These nations are sometimes also referred to as developing or less developed countries.

**Gross Domestic Product (“GDP”)** is an economic statistic which measures the market value of all final goods and services produced within a country in a given period of time.

**Nominal gross domestic product (GDP)** is a GDP figure that has not been adjusted for inflation.

**Purchasing Managers Indexes (PMI)** measure the manufacturing and services sectors in an economy, based on survey data collected from a representative panel of manufacturing and services firms. PMI greater than 50 indicated economic expansion; below 50, contraction.

The **Institute of Supply Management (ISM) Non-Manufacturing Purchasing Managers’ Index (PMI)** (also known as the **ISM Services PMI**) is an indicator of the overall economic condition for the non-manufacturing sector. Levels greater than 50 indicate expansion; below 50, contraction.

The **price-to-earnings (P/E) ratio**, also referred to as the **earnings multiple**, is a stock’s (or index’s) price divided by its earnings per share (or index earnings). The **forward P/E ratio** is a stock’s (or index’s) current price divided by its estimated earnings per share (or estimated index earnings), usually one-year ahead.

**Risk-adjusted return** is a measure of performance relative to its level of risk exposure over a given period of time.

One **basis point (bps)** equals one one-hundredth (0.01) of one percentage point).

**Real yields** are calculated by adjusting stated yields to compensate for inflation expectations over the time period during which the yields are expected to be paid.

The **yield curve** is the graphical depiction of the relationship between the yield on bonds of the same credit quality but different maturities.

**Inverted yield curve** refers to a market condition when yields for longer-maturity bonds have yields which are lower than shorter-maturity issues.

A **credit spread** is the difference in yield between two different types of fixed income securities with similar maturities, where the spread is due to a difference in creditworthiness.

**Investment-grade bonds** are those rated Aaa, Aa, A and Baa by Moody’s Investors Service and AAA, AA, A and BBB by Standard & Poor’s Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined by the manager to be of equivalent quality.

A **current account balance** summarizes the flow of goods, services, income and transfer payments into and out of a country.

**Small cap** refers to stocks with a relatively small market capitalization. **Market capitalization** is the total dollar market value of all of a company’s outstanding shares; it is calculated by multiplying a company’s shares outstanding by the current market price of one share.
The **financial crisis of 2007–2008**, also known as the **Global Financial crisis (GFC)** and the **2008 financial crisis**, was a severe worldwide economic crisis considered by many economists to have been the most serious financial crisis since the Great Depression of the 1930s, to which it is often compared.

“**Bloc**” refers to an association of nations with political or economic interests in common.

**Moat** refers to a defensive boundary that’s difficult to cross; an obstacle to invasion.

“**Print**” As a noun, refers to the publication of a price or economic data point.

The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S.

The **S&P Growth Index** is an unmanaged index consisting of growth stocks within the S&P 500 Index, an unmanaged index of U.S. large-cap stocks.

The **S&P Value Index** is an unmanaged index consisting of value stocks within the S&P 500 Index, an unmanaged index of U.S. large-cap stocks.

The **Russell 2000 Index** is an unmanaged list of common stocks that is frequently used as a general performance measure of U.S. stocks of small and/or midsize companies.

The **MSCI World Index** is an unmanaged index of large- and mid-cap common stocks across 23 developed market countries.

The **MSCI USA Index** is is an unmanaged index of common stocks designed to broadly and fairly represent the full diversity of business activities in the United States.

The **FTSE 100 Index** is an unmanaged index of the 100 largest stocks by capitalization on the London Stock Exchange.

The **OECD Consumer Confidence Index and OECD Business Confidence Index** are broadly used economic indicators reflecting consumer and business confidence levels based on surveys conducted by the Organization for Economic Development and Cooperation.

**Preqin** is a source of data, insights and tools for alternative asset professionals.

**Bloomberg New Energy Finance (BloombergNEF)** is a provider of primary research on clean energy, advanced transport, digital industry, innovative materials, and commodities.

**USDCNY** is a shorthand term for the currency exchange rate between the U.S. dollar and Chinese yuan.

**CNY** is a shorthand term for the Chinese yuan.
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