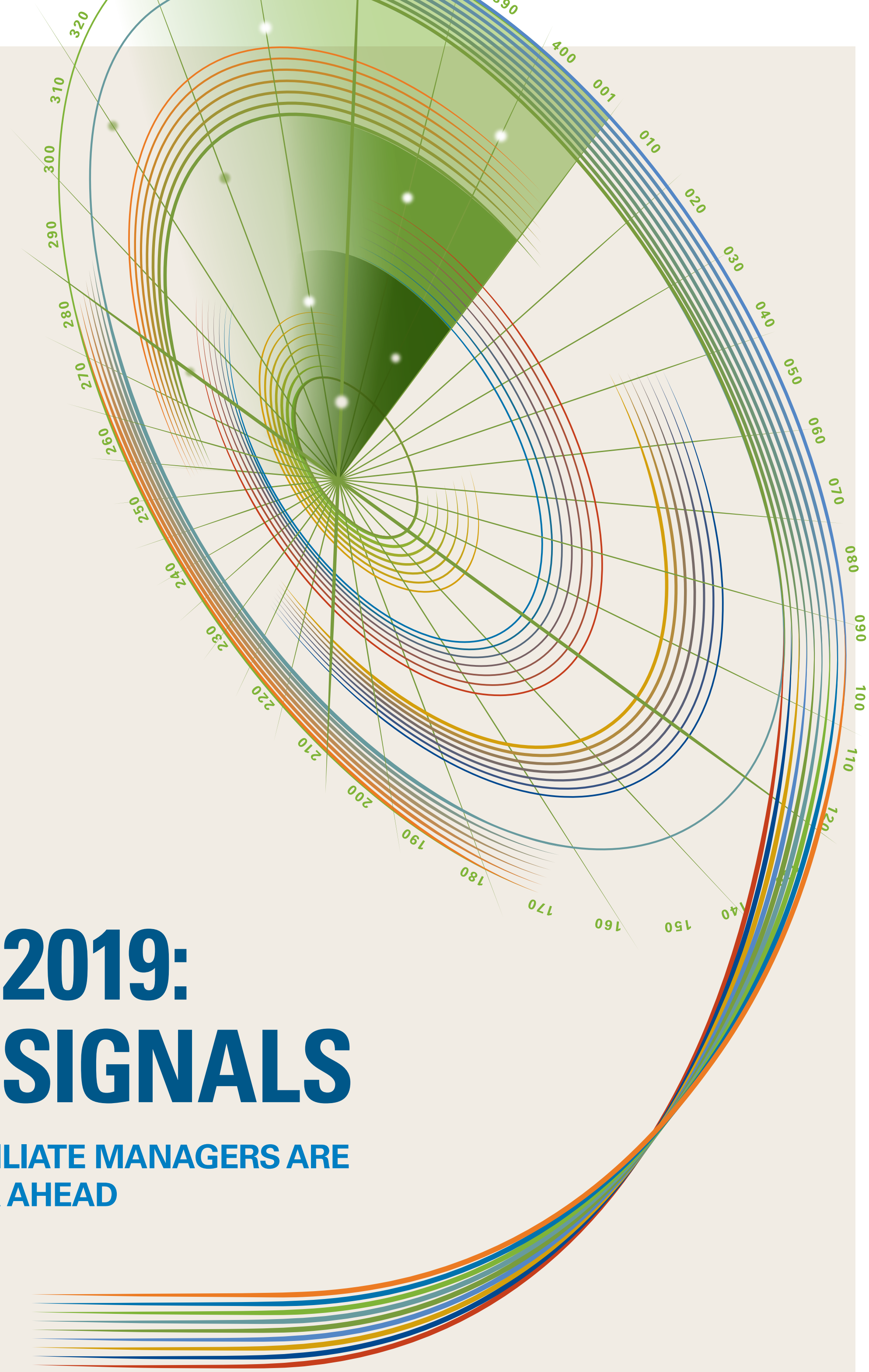


OUTLOOK 2019: SHIFTING SIGNALS

EXPLORE WHAT OUR AFFILIATE MANAGERS ARE SAYING ABOUT THE YEAR AHEAD

LEGG MASON
GLOBAL ASSET MANAGEMENT

Brandywine GLOBAL
CLARION PARTNERS
ClearBridge Investments
EnTrustPermal
MARTIN CURRIE
QS Investors
RARE
Royce&Associates
WESTERN ASSET

OUTLOOK 2019: SHIFTING SIGNALS

Economic indicators continue to signal that a strong US economy can still drive positive global growth. Yet investors are anxiously eyeing a host of issues that could slow global growth – including trade tensions, US Federal Reserve policy and political risks -- and tilt the markets in a new direction. The resulting uncertainty has roiled asset prices worldwide as markets seek a fresh consensus on the prospects for 2019 and beyond.

In Australia, global themes remain a focus and have the potential to dent sentiment but the domestic economic cycle is well behind the US and inflation remains low, so a rate hike is unlikely until well into the year. Equities are not as expensive as in the US either, although the high growth/high momentum part of the domestic market does appear quite stretched relative to cyclicals and value oriented stocks.

We asked some of our affiliates to discuss the key issues that investors should consider going into 2019 and the likely consequences for the markets. Below are the key highlights of their views. Whilst all were concerned about the potential risks, they also see pockets of opportunity. The increased level of volatility is also favourable for active managers (which includes all Legg Mason affiliates) as it creates more dispersion in asset prices and hence more investment opportunities.

AUSTRALIA: RATES ON HOLD, FOCUS ON THE CONSUMER

WESTERN ASSET

"A number of Australian banks have lifted home lending rates despite no policy move from the Reserve Bank of Australia (RBA). This has actually tightened financial conditions and should therefore give more room for pause on monetary policy. Our base case remains for the ***RBA to keep rates on hold at 1.5% until at least the first half of 2020."***

MARTIN CURRIE

"The Australian economy is at an earlier stage of its economic cycle than the US which has already seen significant fiscal stimulus. ***Australia is only just moving into a stimulus cycle*** *(personal income tax cuts)* ***that will be positive for consumption****, putting money in the pockets of consumers."*

VOLATILITY: ALREADY HERE

QS Investors

*"**We expect that the future will look quite different from the past nine-plus years** of rising equity and bond markets amid low volatility. Several key market indicators are currently at historically high or low levels, suggesting ample potential for mean reversion."*

RATES: RIPPLE EFFECTS

Brandywine GLOBAL

*"**We think it would be prudent for the Fed to pause after 1-2 rate hikes in 2019** in order for the lag effects to work their way through the economy. Furthermore, the Fed will continue to normalise its balance sheet behind the scenes in 2019, which implies additional tightening"*

TRADE: UNCERTAINTY WILL CONTINUE

RARE

*"**We don't see the trade war ending any time soon.** There may be "deals" announced with great fanfare on a cease fire from time to time. But an agreement addressing the substantive issues anytime soon seems unlikely to us."*

EnTrustPermal

*"While the Trump-Xi meeting at the G20 Meeting in Buenos Aires offered a respite from trade rhetoric that has negatively impacted markets and global growth, **the risks of further escalation clearly remain and could impact markets over the course of 2019."***

REAL ESTATE: GLOBAL STRENGTH

CLARION PARTNERS

*"Going into 2019, the US commercial real estate sector remains attractive to global investors seeking income and low volatility late in this cycle. **Healthy supply/demand fundamentals are likely to continue to benefit from a relatively solid US macroeconomic backdrop"***

AUSTRALIAN FIXED INCOME

AUSTRALIAN RATES ON HOLD INTO 2020

Australian monetary conditions remain extraordinarily accommodative even as the US Federal Reserve marches toward neutral policy and other major central banks cautiously approach the removal of emergency policy settings.

The Reserve Bank of Australia (RBA) remains patient with inflation as well as with any future adjustment to the cash rate. A number of Australian banks have lifted home lending rates despite no policy move from the RBA. This has actually tightened financial conditions and should therefore give more room for pause on monetary policy. Our base case remains for the RBA to keep rates on hold at 1.5% until at least the first half of 2020.

The unemployment rate has declined over the past year to be half a percent lower at 5.0%, although it has displayed some volatility. Despite this, underemployment persists and this is one reason why wage inflation remains low. Core inflation is anticipated to move back towards the RBA's target band during the second half of 2019.

The residential property sector continues to cool slowly, with the major banks tightening lending standards in response to criticism from the Banking Royal Commission. We are very mindful of the myriad of factors affecting this market and we think there is a little more softening to come. We are monitoring the consumer during this move, as any loss in consumption will affect activity and ultimately employment growth, which has driven the economy recently.

We expect Australian growth to moderate a little from its mid-2018 level but remain close to trend at around 3% into 2019, aided by increased government spending on infrastructure projects and a slightly weaker Australian dollar.

The Australian dollar softened in 2018, particularly versus the strong US dollar as US interest rates increased in response to strong economic data. As we believe that the US Federal Reserve will pause and assess the impact for a period over 2019, the yield differential is unlikely to grow as quickly, but we still see bouts of pressure on the Australian dollar. However, we expect the strong domestic labour market, persistent solid growth and strong commodity prices that have supported the Australian dollar thus far to underpin the currency around the low US$0.70 range.

Loose monetary conditions should continue to favour Australian spread sectors. We believe these sectors will continue to be the best-performing domestic fixed-income assets in 2019 and they remain our major theme. Nonetheless, we continue to be highly critical in our assessments of credit, deal structures and pricing. We remain biased towards corporate bonds, focused at shorter maturities to manage spread risk. We may seek to selectively add risk where market volatility has forced spreads wider than credit fundamentals would justify or as new opportunities present.

AUSTRALIAN EQUITIES

BEWARE THE HIGH GROWTH/HIGH PE SECTOR OF THE MARKET

MARTIN CURRIE

The Australian economy is at an earlier stage of its economic cycle than the US, both in terms of the Philips curve (the relationship between the unemployment rate and inflation) and size of government stimulus. The US has already seen significant fiscal stimulus but Australia is only just moving into a stimulus cycle (personal income tax cuts) that will be positive for consumption, putting money in the pockets of consumers.

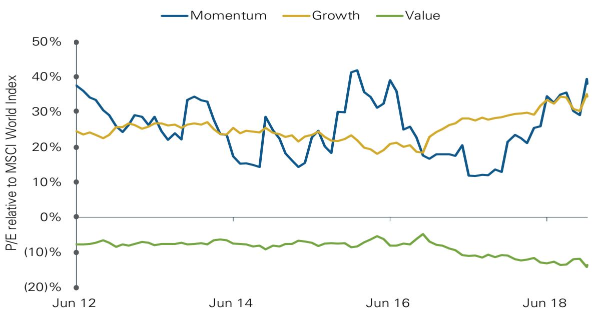
Australia's economic growth is also benefiting from the low Australian dollar, a growing population and strong employment growth and wages growth that should increase household incomes.

Despite the recent fall in house prices, we don't see this a risk as we have found that the 'wealth effect' from higher house prices was not really evident in the early stages of this cycle. People didn't spend more when prices went up, so it's unlikely they will spend less when they fall.

Consumer confidence is holding up because employment and wages growth are starting to come through. And it is consumer confidence that is critical when 60% of Australian GDP is derived from consumption. Add to that the strong fiscal position of the government and we should see tax cuts or rebates that will boost household income. This points to a supportive position for Australian consumers.

Our portfolios are positioned away from the overvalued 'high growth/high PE/high momentum' part of the market in order to maximise long-term income and returns. We prefer sectors that are leveraged to the consumer, such as consumer staples, strongly positioned consumer discretionary and owners of quality shopping centres.

Relative performance of PE ratios by style



Past performance is not a guide to future returns. Source: Martin Currie Australia FactSet; as of 31 December 2018.

We also think that the cyclical sectors have attractive valuations compared to a year ago. As the above chart shows, cyclical sectors have had a big PE de-rate, while the PEs for growth stocks are still way above normal. It's too late to buy the super expensive names, but we also suggest not being fully allocated to cyclicals just yet. Instead, retain some dry powder in safer real asset, defensive exposures to deploy later into the cycle.

Another area of interest to us is the energy sector. Oil is currently undervalued and also underinvested in Australia. For example, there are several new projects in the works in Australia at time when the oil price is well below its long-run average. Coupled with a lack of capex in the past, the Australian energy sector will benefit as oil appreciates again.

GLOBAL FIXED INCOME
FOCUS ON GLOBAL GROWTH

We believe global growth will remain positive in 2019, as US growth moderates slightly and Europe and emerging markets (EM) regain their footing. We also acknowledge four major global risks which may challenge this view. These are a collapse in US-China relations, the Federal Reserve (Fed) overtightening, Italy's governance pulling away from European Union (EU) fiscal norms and the UK separating from the EU via a "hard Brexit." The market, however, is pricing each of these scenarios for extremely negative outcomes. We believe there is room for less pessimism - even some optimism - regarding each of these factors.

US growth is likely to be slower in 2019 as some of the fortuitous factors recently boosting growth begin to fade. Given the 2017 tax bill's incentives, one would think capital spending would continue to hum, but recent capital goods data has been spotty, and homebuilding looks to have embarked on a downtrend. If foreign trade and inventories revert to 2015-2016 trends and either equipment investment or housing slow, economic growth could drop to around 2.0 - 2.25%. We think the claims of runaway growth are exaggerated and that we will likely see more modest performance in 2019, along with continued low inflation.

The Fed's renewed focus on contained inflation, risk management and a lack of certainty about equilibrium or neutral rates suggests a more dovish direction moving forward. What's more, Fed Chair Jerome Powell just declared that the Fed is very near the neutral range (thought to be a fed funds rate of 2.5 - 3.5%).

We're optimistic that the new tone will prove helpful, but it's too soon to tell. More importantly, monetary policy has been tightening for two years and fiscal stimulus is waning. We think as the Fed comes to face more seriously a moderating growth and inflation outlook, a pause will be both signaled and warranted.

EM appear to be the most undervalued asset class. Extreme market pessimism pulled the entire asset class downward in 2018 despite important positives in the sector, such as remarkably subdued inflation and resilient sovereign and corporate balance sheets.

Index yield spreads between EM debt and developed market (DM) debt are near 2008 and 2016 levels, 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, we believe EM would be the biggest beneficiary of any attenuation of the global risks.

GLOBAL FIXED INCOME
THE LIMITS OF US GROWTH

Brandywine GLOBAL

One of the major global macro themes of 2018 centered on robust US economic growth relative to the rest of the world. Supercharged US growth and countertrend dollar strength were the consequences of late-cycle stimulus. We think divergence in relative growth has its limits, and therefore expect these growth rates to converge in 2019. Federal Reserve (Fed) policymaking and relations between the US and China should be the greatest determinants of global economic growth in 2019.

The Fed has two paths to follow in 2019: either hike rates 1-2 times or 3-4 times before taking a pause in its current tightening cycle. We think it would be prudent for the Fed to pause after 1-2 rate hikes in 2019 in order for the lag effects to work their way through the economy. Furthermore, the Fed will continue to normalise its balance sheet behind the scenes in 2019, which implies additional tightening.

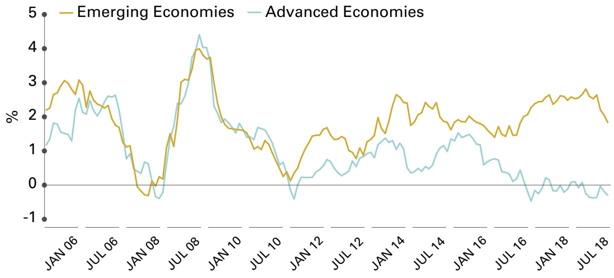
We expect US economic growth to come off its lofty levels as the supercharged effects of tax cut stimulus starts to wear off. We would not be surprised to see a gradual deceleration in US GDP growth, which could fall from current levels around 3.5% to something around 2.0-2.5% by the end of 2019.

Ultimately, our 2019 outlook will be an extension of our current thinking. There are pockets of the global bond and currency markets that exhibit price dislocations, where asset prices do not reflect actual fundamentals. Looking at the real 10-year government bond yields within emerging and developed markets in the chart below, these valuation anomalies become clear. Inflation expectations priced into emerging market bonds are just too high relative to actual inflation rates, while expectations for the developed world are low. We think adjusting inflation expectations in 2019 will compress this yield spread.

Real 10-year government yields

Emerging markets versus developed markets

Source: Macrobond as of 11/30/18. Reflects GDP-weighted average of the real yields (based on Consumer Price Indexes) for countries in each



category. 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.

There are risks to our scenario. The most bearish outcome would be a combination of an overly hawkish Fed along with an escalation from trade tension to an all-out economic Cold War between the US and China. How these issues get resolved over the course of 2019 will be central to global asset market performance and our investment outlook.

GLOBAL EQUITIES
CHOPPY MARKETS AHEAD

QS Investors

The global economic expansion and equity bull market that followed the Global Financial Crisis (GFC) is well past the nine-year mark, making it the longest bull-run in US history.

While economic fundamentals are still sound in the US, and bull markets rarely die of old age, 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, a feature that had been all-but-obscured by the long bull-run.

We expect that the future will look quite different from the past nine-plus years of rising equity and bond markets amid low volatility. At this juncture, several key market indicators are currently at historically high or low levels, suggesting ample potential for mean reversion:

- Despite the more recent correction, valuations in US equity markets 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 (US, China, technology and growth/momentum stocks) and the rest of the market (international, defensive sectors and value stocks), which exhibit more attractive valuations.
- Since March 2009, the US market generated over 400% cumulative returns, outpacing international equities by over 200%; growth has outperformed value in the US by over 100%; and five US stocks have contributed over 50% to S&P 500 Index returns, year-to-date.
- In addition, market volatility is expected to increase as the Federal Reserve and central banks across the globe exit accommodative monetary policies, global growth continues to soften, and markets process idiosyncratic events such as Brexit, China-US trade tariffs and other.

All of these features will likely make for choppier markets ahead and a potential repricing of risk and return.

GLOBAL EQUITIES
CURRENT VOLATILITY, LONG TERM OPPORTUNITY

MARTIN CURRIE

In the coming year, tightening labour markets, rising wages and reasonably strong economic activity in the US will continue to lead the US Federal Reserve (Fed) to increase rates. There is, of course, a risk that the Fed will tighten too quickly, and that the combined effects of balance-sheet reduction and conventional rate hikes may contract economic growth much earlier than expected in 2019. While this is not our central forecast, it is a risk of which we remain acutely aware.

Higher rates are not going to be good news for some expensive equities out there (especially for the stocks of companies which have gorged on cheap liquidity for the last decade), as among other things they mean higher borrowing costs. As such, we expect to see volatility persisting in equity markets for some time to come.

Clearly, there is a 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 – that is, 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 be a preoccupation for markets. Central bank policies will also remain an important focus, in the context of economic momentum which could be weakening across the European Union, China and the US.

The market is also becoming increasingly anxious about risks of a recession, which is likely to add further volatility in 2019. There is certainly the potential here for investors with a shorter time horizon to be spooked. However, we believe these risks create opportunities for long-term investors such as ourselves. Specifically, to initiate holdings in companies that we see as being exposed to long-term secular growth drivers at attractive valuations.

We continue to see a huge amount of opportunity for investors looking beyond their domestic markets. For instance, emerging market equities are around their long-term price-to-earnings average. However, we believe the asset class still represents good value in terms of an international equity allocation. Return on equity is fairly synchronised with developed markets and importantly, price-to-book and price-to-equity values remain low relative to history and developed markets.

GLOBAL INFRASTRUCTURE
TIME TO GET DEFENSIVE?

RARE

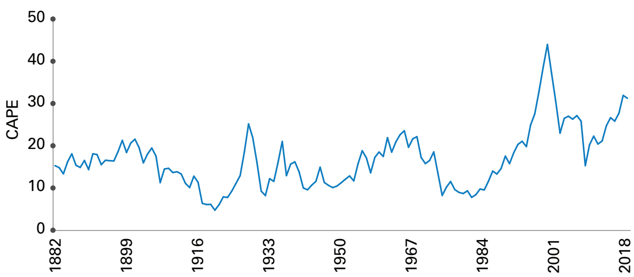
It is an old investment adage that "markets climb a wall of worry". Markets certainly did successfully climb this wall following the Global Financial Crisis (GFC) but had a helping hand. The big global central banks, led by the Fed, through extraordinary loose monetary policy (exemplified by Quantitative Easing), provided a ladder and helpfully propped it against the wall.

Now, however, the ladder is slowly being pulled away as rates are hiked, and QE turns to QT (Quantitative Tightening). We fear that 2019 may leave markets perched, like Humpty Dumpty, atop the wall. While we hope 2019 doesn't bring a "great fall", hope is not a strategy. We made the call early in 2018 that we believed it was prudent to resist the urge to ride the bull market right to the inevitable end and to begin moving portfolios to a more defensive posture.

Since then we've seen volatility pick up and, unlike in January 2018, the leading US tech stocks (affectionately known as FAANGs – Facebook, Apple, Amazon, Netflix and Google) have not reasserted leadership and led a bounce back. We think this provides affirmation of our view that we are seeing a market regime change which is likely to continue to play out in 2019.

The counter-argument to this view (and one we debate internally) is the strength of the US economy - none of the key recession indicators we monitor are flashing red. What we point to in response is the vulnerability of the US share market to a correction. Valuations, on any sort of long-term valuation metric such as Cyclically Adjusted PE (CAPE), Tobin's Q and total market cap/GDP, look toppy. As the chart below shows, the only other points in history where the S&P 500's CAPE was higher was on the eve of the 1929 crash that ushered in the Great Depression; and at the height of the dot-com bubble in 1999/2000. It appears Humpty Dumpty is currently sitting atop quite a high wall indeed!

Cyclically Adjusted Price/Earnings Ratio (CAPE)



Source: http://www.econ.yale.edu/~shiller/data, RARE Infrastructure. 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 key risk is the Sino/US trade war. China is a centrally planned economy. We are skeptical that China will give in to US demands to reduce government intervention into the economy. The US position seems just as entrenched. We don't see the trade war as ending any time soon. The trade war is impacting global economic growth. At some point this will begin to impact S&P 500 earnings. Indeed, more recent reporting commentary has seen a sharp pickup in warnings regarding trade and the outlook for corporate profits.

All in all, it would seem to us this is a recipe for continued volatility but it would be premature to reduce equity exposure too drastically at this point. Instead, we think increased defensive equity exposure is in order, and infrastructure stocks are one of the key ways investors can achieve this.

GLOBAL REAL ESTATE
AN EXTENDED BUSINESS CYCLE

CLARION PARTNERS

If the current business cycle continues through July 2019, it will be the longest in modern US history. This naturally begs the question: How much longer can this cycle continue? 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 US unemployment rate standing at 3.7%, the lowest level in nearly 50 years, the current expansion does not have the makings of a boom and bust cycle. Real GDP has only grown 18% since the prior market peak, compared to the 40% in the 1990s and 50% in the 1960s.

We believe this slow and steady pace of expansion may prolong the current business cycle as there are no huge imbalances or signs of overheating in the economy. As commercial real estate (CRE) investors, we prefer this slow and steady pace of growth as demand for commercial space is strong, but not so robust as to spur excess lending and speculative new development.

Going into 2019, the US commercial real estate sector remains attractive to global investors seeking income and low volatility late in this cycle. Healthy supply/demand fundamentals are likely to continue to benefit from a relatively solid US macroeconomic backdrop in the following ways:

- Steady GDP and job growth - approximately 2.4 million new jobs were added to the economy over the past year amid accelerating wage growth. Property owners should have a greater ability to increase rents.
- Strong demographics – over 1.4 million new households were formed over the past 12 months, generating substantial new demand for housing and commercial space.
- Higher replacement costs – rising construction materials and labor prices have significantly escalated replacement costs, providing room for additional asset appreciation.
- Elevated cross-border capital inflows – high foreign inbound investments have improved capital availability and overall liquidity, thereby creating greater competition for high-quality properties.
- Rising interest rate environment – the potential rise in interest rates is generally viewed as a negative for cash and fixed-income bonds, which may prompt investors to rotate more capital into inflation-hedging asset classes including CRE.

We expect sustained investor interest in warehouses/e-commerce supply chains, rental housing, creative offices, strategically located retail assets and health care properties within top employment and retirement hubs. Investment themes in which we see potential include socioeconomic diversity, urbanisation, demographic demands and high-growth industry clusters (e.g. high-tech, new media, and life sciences).

Based on our 2019-2021 outlook, Clarion's near-term strategy favors industrial, urban multi-family, and central business district (CBD) office, with a focus on selective value-add opportunities, especially in top secondary markets and premier suburban submarkets outside the major markets.

GLOBAL ALTERNATIVES
A PLETHORA OF RISKS

EnTrustPermal

We believe US economic growth and earnings growth are going to decelerate in 2019. 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. Normalisation does not mean recession, however it is notable how many downside risks exist today:

- **US-China relationship** – Ultimately it is about more than just trade - there are other issues that are strategic in nature, including technology, intellectual property and national security. While the Trump-Xi meeting at the G20 Meeting in Buenos Aires has offered a respite from the trade rhetoric that has negatively impacted markets and global growth, the risks of further escalation clearly remain and could impact markets over the course of 2019.
- **Continued monetary tightening** – while the US Federal Reserve may be closer to the ephemeral "neutral" level implying a more data dependent approach, the European Central Bank is set to begin to taper their asset purchases and the Bank of Japan my be forced to relax its policies around yield curve control to support their banking system. Tighter financial conditions can be a headwind to growth.
- **Margin compression** – Rising costs via wage pressures, higher logistics and materials costs may negatively impact margins. Tax reform was a one-time benefit that will not contribute to earnings growth again in 2019. With the unemployment rate at the lowest level of the expansion, wage pressures are expected to continue. In addition, tariffs will begin impacting margins.
- **Corporate credit** – Widening credit spreads will negatively impact borrowing costs. Low interest rates enabled companies to increase leverage and engage in large share buybacks to support earnings per share (EPS) growth during the expansion.
- **Middle East geopolitics** – Oil prices below $60 per barrel are not sufficient to meet most Middle Eastern economies budgetary targets. OPEC and Russia may look to cut production to maintain prices creating further tension with the US.
- **European politics** – Brexit and Italy continue to present potential flashpoints that can negatively impact European growth. The sense of populism is difficult for markets to discount.

So market volatility is expected to remain elevated and equity markets will be forced to rely on dividends and earnings growth for much of the gains next year as any increase in equity market valuations are unlikely.

We also believe the environment for active management is greatly improved. The shift from quantitative easing to quantitative tightening will impact liquidity, lead to higher risk premiums and impact corporate performance leading to higher dispersion in equity prices.

The full text of all the affiliate articles mentioned above can be found at:

https://www.leggmason.com/global/campaigns/annual-outlook.html

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