LEGG MASON
GLOBAL ASSET MANAGEMENT

ANNUAL OUTLOOK

WHAT COULD GO RIGHT IN 2017

Things didn't always go as expected in 2016. The U.S. election, U.K. Brexit vote and the Fed's U-turn on rates took many investors by surprise.

Yet worries about volatility proved unfounded. Some asset classes posted solid gains, defying pessimism, showing that opportunity can arise despite the many real risks.

With that in mind, we asked our investment managers to identify what could happen if things go right in 2017...

www.LeggMason.com/AnnualOutlook/

THE MIDDLE WAY: GOLDILOCKS RATES AND GROWTH

Inflation expectations have surged higher in the wake of the U.S. election — which could set the stage for higher-than-anticipated interest rates, which in turn could restrain growth. Is there a middle way that could be "just right" for the markets?

Ahead: A virtuous circle?

As always, there are issues for investors to ponder — starting with the potential for an upward spiral in inflation and the challenge to the ability of the Federal Reserve (Fed) to respond appropriately. There's also the potential for government spending to combine with tax cuts to add to the U.S.'s $19 trillion debt, driving up long-term interest rates by adding to the already sizable supply of U.S. Treasuries in that part of the market. Outside the U.S., there's concern about China's growth as its financial system absorbs the expanding market for local debt; about what's next for Japan if its aggressive spending and still-expansionary monetary stance fail to ignite sustainable growth; and in Europe, whether the austerity policies promoted by the World Bank, the IMF and the ECB could continue to hamper economic recovery — and whether upcoming elections convince governments to loosen their purse strings.

But what if rates, politics, and growth align in a virtuous rather than vicious circle? Moderate economic improvement in the U.S., combined with measured Fed rate hikes that don't choke off recovery, is well within the realm of the possible. If so, the pickup in inflation expectations could stabilize around the Fed's 2% objective. If so, U.S. equities may be right in reflecting the probability of a brighter future with continued earnings improvement as well as resurgent demand — a welcome change for corporations. And for fixed income, this could suggest that the year-end rout overstated the probability of a negative outcome.

Inflation awakening: Market expectations on the rise

Source: Bloomberg, as of December 6, 2016. **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

WESTERN ASSET

"Markets reacted to the election of Donald Trump with a quick repricing of many assets. Bond yields moved sharply higher on the view that tax cuts and infrastructure spending could boost growth and inflation, and in doing so allow the Fed to follow through with more rate hikes. The U.S. dollar moved back to its cycle highs, reflecting renewed optimism about policy and growth. And banks and pharmaceuticals outperformed on the prospect of regulatory relief and a more business-friendly environment. Should Trump manage to avoid the many pitfalls facing any new president — not to mention those facing a new president with such a unique background — then these positive story lines could very well define markets in 2017."

Royce&Associates

"With global commodity prices stabilizing or rising, the yield curve steepening, and an infrastructure spending bill looking likely, the odds of a cyclical upturn look increasingly strong. This would also be a significant positive for cyclical areas such as Industrials and Information Technology. However, there are other positives for these sectors outside a period of stronger top-line growth. For example, many industrial businesses were so wildly oversold in 2015 and into the beginning of 2016 that, even with their recoveries since the February trough, their valuations still look reasonable to us."

ClearBridge Investments

"The consensus is that interest rates are going up, with growth-stimulative policies from President-elect Donald Trump adding to the potential for higher inflation and subsequently higher rates. We take a more moderate view of inflation and rate increases, and can envision a scenario where 10-year U.S. Treasury yields remain in an amenable range between 1.7 and 2.5%. If yields stay in this range, investors would not need to worry about rates rising enough to pressure valuations and liquidity, or dropping enough to raise recession fears. We believe this moderate scenario would promote an uptick in growth from low levels, but not enough to create inflationary pressures. Such an environment could lead to better than expected market returns.

In our opinion, we are at point in the market cycle where inflation concerns, fueled by stronger wage growth, are beginning to appear. However, we do not see them as a big risk. Profit margins peaked two years ago for most companies, and normally there is a delay before that margin pressure slows compensation gains. We also don't expect oil prices to rise materially — OPEC will have difficulty agreeing to production cutbacks — and restrained commodity prices remove another inflation pressure. Under this measured scenario, we see China doing its part by controlling its maturing economy while averting both a hard landing and an acceleration that could spark price pressures."

> If yields stay in this range, investors would not need to worry about rates rising enough to pressure valuations and liquidity, or dropping enough to raise recession fears.
> ClearBridge Investments

THE UPSIDE OF INWARD: POPULIST POSITIVES

The past year saw more voters and governments turning inward, with globalism losing ground to localism. But one positive outcome of this populist surge could be a renewed interest in domestic investment worldwide.

Populism: Nation-building at home?

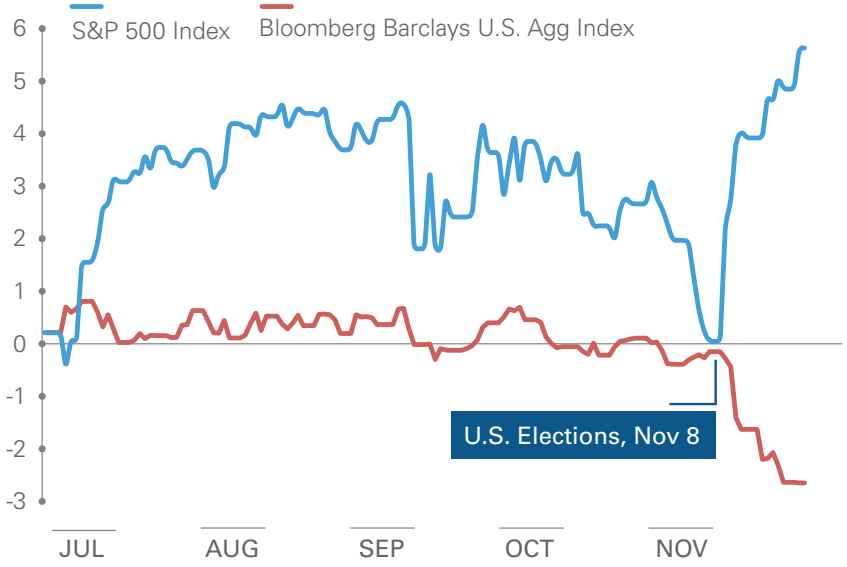
The Brexit and Trump wins both rattled the established political economic order, channeling go-it-alone protectionist sentiment and challenging the principle of globalization. Drawing power from the decades-long economic decline of the middle class, discontent focused on job losses and income stagnation, amid increased interdependence of the world's economies.

But financial markets have focused so far on the potential for upside. Implicit in this inward turn: a possible political tilt in favor of fiscal stimulus, which in turn would require increased government borrowing. That borrowing is a hot-button issue in Europe as well as the U.S., where many factions resist adding to already-substantial sovereign debt.

It's unclear so far how these two opposing views will be reconciled, either in the U.S. or the U.K. Yet in either economy, the focus on domestic economic health could provide renewed interest in investment of a very local type: refurbishment of bridges, roads, water systems and transportation.

> There is a lot of focus on the downside of populist politics, with no one talking much about the upside.
>
> RARE Infrastructure

Populist pop-and-drop: Percentage price change, stocks and bonds (July 1, 2016 – November 22, 2016)



Source: Bloomberg, as of November 28, 2016. **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

RARE

"There is a lot of focus on the downside of populist politics, with no one talking much about the upside. What comes out of populist politics is a need for governments to start to get 'looser with their purse strings' and direct spending toward their local markets. What we could see is that government fiscal spending starts to take over from central banks' monetary policy. Given that government spending is a lot easier to understand and predict than monetary policy, this could be a very good thing."

Brandywine GLOBAL

"Although the threat of extreme protectionism poses risks, a more moderate stance on globalization may emerge from the rhetoric that characterized Brexit and the U.S. election. A pro-growth U.S. economy — based on infrastructure investment, lower taxes for individuals and corporations, decreased regulation, and more energy investments — should ultimately be a net positive for global economic growth, even for developing countries like Mexico."

EnTrustPermal

"The surprise of 2017 may be that the specific policies around trade, fiscal policy and regulation that are done in moderation are favorable to both economic growth and certain sectors of financial markets."

martin currie

"In Europe, pre- and post-Brexit, profitability has been recovering. Elections, rising antiestablishment sentiment and the re-emergence of Greek debt will no doubt color political discourse, making consensus hard to come by. However, the potential for change may actually provoke harmonization. The backdrop of continued low growth and political separatism could be the catalyst for governments to take action to stimulate their individual economies, which could shift the region's overall direction. Projects which will have an immediate impact are where we expect to see the most interesting prospects for long-term growth. Companies in materials and industrials sectors would benefit if governments look to increase direct spending, and whilst U.K. house builders have seen their fortunes dip following Brexit, there are positive signs for those companies with pan-Europe real estate exposure."

> The backdrop of continued low growth and political separatism could be the catalyst for governments to take action to stimulate their individual economies.
>
> Martin Currie

PHASE SHIFT: FROM MONETARY TO FISCAL

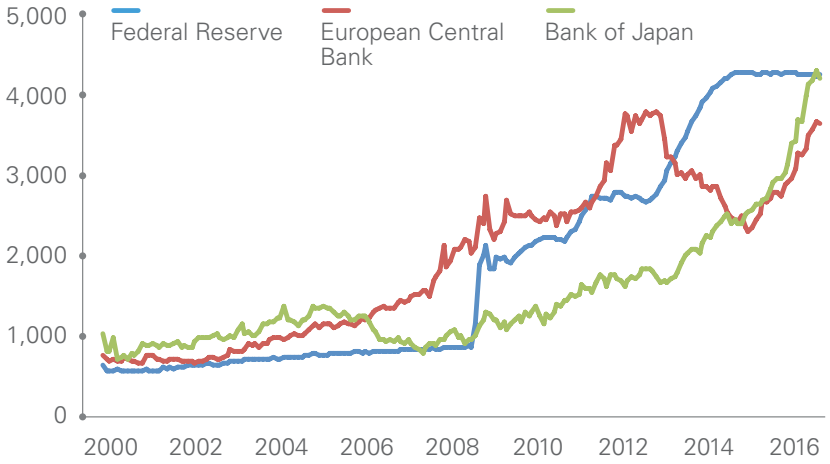
More and more, the world's central banks are concluding that the effectiveness of monetary stimulus may be waning — with greater fiscal stimulus needed to truly jumpstart growth. Trump's campaign comments favoring infrastructure spending, if realized, could mark a turning point in the monetary-to-fiscal shift.

An end to budgetary restraint?

The burden of recovery from the financial crisis has fallen largely on the world's major central banks in the wake of the 2008 financial crisis, with the World Bank and IMF committed to austerity in Europe and the U.S. Congress exercising budget restraint. China, on the other hand, fueled its massive infrastructure and real estate spending with its immense foreign reserves and internal borrowing.

To fill the gap left by fiscal restraint, central banks' role quickly expanded, from providing liquidity to support the financial system to getting the world's economies back on track. Yet there's a growing consensus, even within the central banks themselves, that their tactics are growing less effective over time. The eagerness with which financial markets greeted the prospect of fiscal largesse as fulfillment of Trump's campaign promises offered some indication of markets' readiness to overlook the impact on the budget — and general lack of specifics. That said, the mood of financial markets appears clearly in favor of giving fiscal remedies a turn at bat, at least in the short run. Or until the bills start coming due.

Filling the world's punchbowls: Central banks' balance sheets tell the tale ($ billions)



Source: Bloomberg, as of November 28, 2016. **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Brandywine GLOBAL

"We still see a tremendous amount of both structural and cyclical change flowing through the system. Instead of secular stagnation, secular forces appear to be signaling the start of a regime shift. We believe the world is moving from an investment regime dependent on developed markets' monetary policy to one based on real growth."

CLARION PARTNERS

"It is estimated that there is approximately $70 trillion of cash currently sitting on the sidelines. To be sure, in a low or negative interest rate environment, the opportunity cost of holding cash is low. However, a massive fiscal stimulus program under Trump's proposal, including a $1 trillion investment in infrastructure and enormous tax cuts, has already boosted inflation expectations. Therefore, it is conceivable that some of the cash on the sidelines may finally be "forced" to jump into the market for higher return opportunities, benefiting many asset classes as a result."

EnTrustPermal

"The baton is going to be passed from focus on monetary policy to focus on other levers of growth. Improved wage growth will eventually feed into higher inflation readings. Higher long-term interest rates and a steeper yield curve are likely. Higher interest rates will lead to increased volatility across asset classes. The higher volatility would be welcome if it is due to better economic data. Investor focus would turn to fundamentals, not what central banks can do to inflate asset prices."

We believe the world is moving from an investment regime dependent on developed markets' monetary policy to one based on real growth.

Brandywine Global

CAPITAL DEPLOYMENT: FROM CASH TO CAPEX

Low rates and cheap borrowing have encouraged companies to buy back their own shares and buy each other, rather than investing in the productive capacity of their own business. Yet as rates go up, cash may again be deployed toward increasing future capacity and productivity.

There's room for M&A activity and capital investment to rise

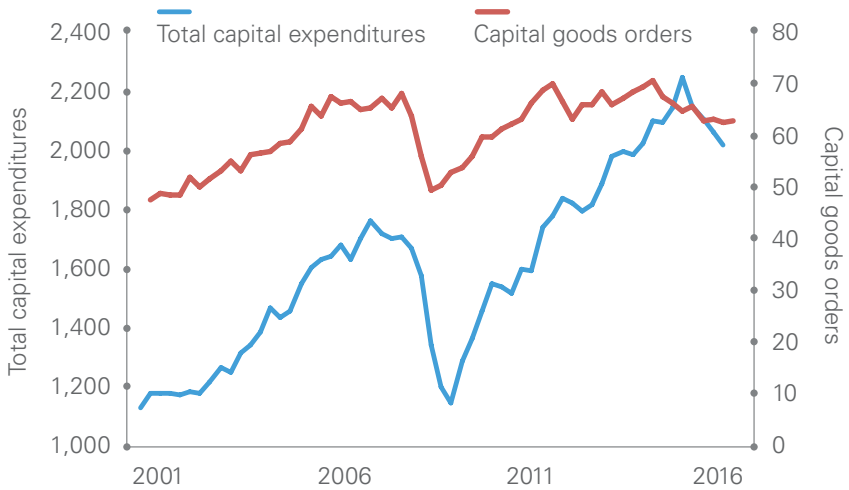
Through November 2016, the value of announced mergers and acquisitions globally was $2.85 trillion;[1] $1.99 trillion of which was in the U.S. In the second quarter of 2016 alone, buybacks among S&P 500 companies amounted to $125.1 billion, and for 137 companies in the S&P 500, buyback spending for the 12 months ended June 30 exceeded their own earnings for the same period.[2]

These binges were fueled by a powerful combination of balance-sheet cash and rock-bottom borrowing costs. But as final demand increases in a growing economy, manufacturing companies and others may find the need to reinvest in domestic production, including hiring more aggressively — especially if global trade becomes less fluid. The demand created by a renewal of fiscal spending could very well drive cash into the quest for improved productivity as demand meets constrained supply — even as corporate debt levels grow.

[1] Source: Bloomberg.

[2] Source: FactSet.

Capital goods orders flatten, capex fades again ($ billions)



Source: Bloomberg, as of November 28, 2016. **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Brandywine GLOBAL

"In 2017, we may finally welcome a sustained break in the deflationary, secular trend that has challenged developed markets for the last several years, supported by an increase in fiscal stimulus and particularly infrastructure spending. The expected resulting uptick in growth should help boost corporate profits and CEO confidence, which in turn could trigger a needed recovery in capital expenditures."

ClearBridge Investments

"With interest rates range-bound, financing will remain affordable and allow companies to keep engaging in shareholder-friendly actions. Share buybacks, for example, have been driven by taking debt on the balance sheet at cheap rates, and we expect companies will continue to be strong buyers of their stock. Merger and acquisition activity, fueled by affordable financing, should also remain strong as companies look for ways to supplement organic growth."

CLARION PARTNERS

"Looking forward into 2017, 'animal spirits' could emerge as a growing sense of optimism sparks a surge in consumer spending. As a result, business investment, which has been a key missing component in the current recovery and expansion cycle, could finally break out of its slump."

Through November 2016, the value of announced mergers and acquisitions globally was

$2.85 trillion

Business investment, which has been a key missing component in the current recovery and expansion cycle, could finally break out of its slump.

Clarion Partners

THE X FACTOR: ANIMAL SPIRITS

In the short term, markets respond strongly to shifts in sentiment; witness the tremendous and unexpected response to the radically changed narrative for U.S. growth after the presidential election. Will the optimism survive the realities of a new year? Or will the shift to optimism create its own positive reality?

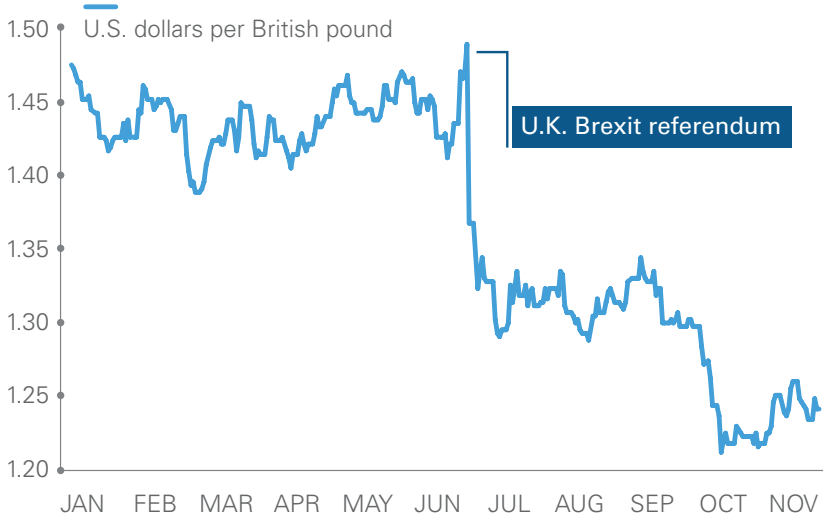
Biases shifting to the positive?

The rapid shift in financial markets since the U.S. elections serves as a powerful reminder that a shift in the story can make all the difference, and the belief in a better future can create its own positive momentum — just as persistent pessimism can nip a recovery in the bud.

Two powerful examples from 2016: Without enacting a single piece of legislation or issuing an executive order, Trump's election has transformed the emotional landscape for investors as well as reflecting the transformation of the political environment. Instead of reacting slowly as changes in fiscal policy unfold, U.S. equities have acted as if the changes have already taken place — despite the political headwinds they could encounter.

The same is true for the U.K., where the timing and final impact of Brexit are far from certain — and yet the British pound dropped some 16% against the U.S. dollar, while fueling a 13% rally in the U.K. equity market. In emerging markets (EM), the fear of tariffs that could take years to enact has driven "hot money" out of economies where fundamental prospects remain strong — leaving only a few well-nourished babies in their tubs after most of the bathwater has gone down the drain.

The cost of pessimism: the pound plummets



Source: Bloomberg, as of November 28, 2016. **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

QS Investors

"When we think about market-moving events, investors often want to react. The harder thing to do sometimes is not to react. That's exactly where we think we are right now in terms of making sure that when we have these types of situations that investors don't overreact. The key is to make sure you look at the entire investment universe and really keep to your particular discipline — the one you committed to in calmer times — until things become more clear. Because, again, the one sure thing is that we're going to be accompanied by significantly more uncertainty over the next several months than we were over the last."

RARE

"Fiscal stimulus which is locally focused on the back of populist politics will likely lead to people feeling more positive about life. This should strengthen consumer sentiment and increase consumer spending."

Royce&Associates

"In our view, the rally that began off the small-cap trough in February 2016 has further to go in this current cycle, and we think that leadership in 2017 will remain with value stocks, as it has since June 2015."

Western Asset

"There are two areas where initial market reaction to a Trump presidency may have been overly pessimistic. The first is emerging markets (EM). An acceleration of global growth is normally positive for EM. Of course, there is a risk of more restrictive trade policies limiting the growth that will be shared. But given how much the U.S. relies on the import of commodities and consumer goods, there is a good chance that a mix of faster U.S. growth offset by somewhat higher tariffs will, on net, benefit EM economies.

The second is long U.S. Treasury bonds. Even as the near-term prospects for growth have improved, the medium-term headwinds haven't abated. An aging global population, lower productivity growth and oversupplied input markets keep pressure on inflation muted, which will help to cap the amount of yield increases from here. In addition, it's unlikely that the risk-on environment will proceed in an uninterrupted straight line; almost nothing ever does."

> We're going to be accompanied by significantly more uncertainty over the next several months than we were over the last.
>
> QS Investors

LEGG MASON
GLOBAL ASSET MANAGEMENT

INVESTMENT RISKS:
Forecasts are inherently limited and should not be relied upon as indicators of actual or future performance.

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.

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

DEFINITIONS:
Emerging markets 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.

Current yield is annual income (interest or dividends) divided by the current price of the security.

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 **Organization of the Petroleum Exporting Countries (OPEC)** is a permanent intergovernmental organization of 12 oil-exporting developing nations that coordinates and unifies the petroleum policies of its member countries.

The **World Bank** provides financial and technical assistance to developing countries around the world. Established in 1944, it is based in Washington, DC.

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.

The **5-year, 5-year forward breakeven inflation rate** is a measure of expected inflation derived from "nominal" Treasury securities and their "real" counterparts — inflation-protected TIPS securities.

U.S. Treasury Inflation Protected Securities ("TIPS") are bonds that receive a fixed, stated rate of return, But they also increase their principal by the changes in the CPI-U (the non-seasonally adjusted U.S. city average of the all-item consumer price index for all urban consumers, published by the Bureau of Labor Statistics). TIPS, like most fixed income instruments with long maturities, are subject to price risk.

The **Bloomberg Barclays U.S. Aggregate Index** is a broad-based bond index composed of government, corporate, mortgage and asset-backed issues, rated investment grade or higher, and having at least one year to maturity.

Yield to worst (YTW) is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

IMPORTANT INFORMATION:
All investments involve risk, including possible loss of principal.

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

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

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

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

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

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

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

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

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

ALL INVESTORS IN THE U.K., PROFESSIONAL CLIENTS AND ELIGIBLE COUNTERPARTIES IN EU AND EEA COUNTRIES EX U.K. AND QUALIFIED INVESTORS IN SWITZERLAND:
Issued and approved by Legg Mason Investments (Europe) Limited, registered office 201 Bishopsgate, London EC2M 3AB. Registered in England and Wales, Company No. 1732037. Authorized and regulated by the Financial Conduct Authority. Client Services +44 (0)207 070 7444.

ALL INVESTORS IN HONG KONG AND SINGAPORE:
This material is provided by Legg Mason Asset Management Hong Kong Limited in Hong Kong and Legg Mason Asset Management Singapore Pte. Limited (Registration Number (UEN): 200007942R) in Singapore.

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

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

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

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

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

ALL INVESTORS IN THE AMERICAS:
This material is provided by Legg Mason Investor Services LLC, a U.S. registered Broker-Dealer, which includes Legg Mason Americas International. Legg Mason Investor Services, LLC, Member FINRA/SIPC, and all entities mentioned are subsidiaries of Legg Mason, Inc.

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