

# Legg Mason Core Plus Global Bond Trust

## Objective

The Trust aims to earn a before fees and taxes return of 1.25% p.a. in excess of its benchmark over rolling three-year periods.

## Benchmark

Barclays Capital Global Aggregate Index (hedged into Australian dollars)

## Value

\$23,969,765.

## Performance (before fees and taxes)

	Trust %	Benchmark %
1 month	1.29	1.25
3 months	3.54	3.35
1 year	19.45	11.51
3 years p.a.	5.64	9.79

Past performance is no indication of future performance.

## Profile

### Portfolio Characteristics

Duration (years)	5.2
Average credit quality (Standard & Poor's)	AA

### Sector Allocations

	%
Government	70.5
Investment grade	22.2
Mortgage and asset backed	1.2
High yield	4.9
Emerging markets	0.0
Banking Government Guaranteed	0.4
Cash and other	0.8

## Market Review

Markets struggled to digest a barrage of announcements during June, the consequences of which had yet to be determined. The highly anticipated shift in China's exchange rate regime was finally announced, although it seemed a statement of intent rather than a roadmap for future policy. While details remained thin, it seems that China will reintroduce the crawling peg that existed from July 2005 until July 2008, at which time a parity of 6.83/USD was fixed. The Peoples Bank of China will allow a +/-0.5% daily trading band around a central parity against the US dollar. Movements may begin to reflect a broader basket of currencies, consistent with China's major trading partners. Appreciation expectations remained modest. Non-deliverable forward contracts implied yuan appreciation of around 3% over the next 12 months against the U.S. dollar, below expectations seen earlier in the year.

In the U.K., the Chancellor of the Exchequer announced that the pace of fiscal consolidation will be accelerated, bringing the structural budget back into surplus by 2015. This will be achieved in part with a rise in the consumption tax, which should put further upward pressure on inflation. A number of Bank of England members flagged this as concerning. Turning to the other side of the pond, the U.S. Congress defeated a jobs bill and both the G20 and the International Monetary Fund released statements arguing for the prioritisation of fiscal deficit reduction. The financial reform bill in the U.S. appeared close to being signed into law. Many of the provisions were intentionally left open to interpretation; this means that regulatory agencies will still have scope to adjust its impact.

Economic data suggested a slight moderation in the pace of economic expansion, and inflationary pressures remained muted. Manufacturing indices declined around the globe and confidence surveys suggested that consumers were becoming more cautious. Home sales plunged in the U.S. as the first time homebuyer tax credit expired. Most major central banks held steady. The Bank of Canada was an exception, and surprised markets somewhat by raising its policy rate by 0.25% to 0.50%. Sweden's Riksbank followed shortly after month end with an identical move. A few Bank of England policy-makers raised concerns that U.K. inflation had not dampened in line with U.S. and European inflation.

Government bonds performed well as the bid for low risk assets increased. Ten-year yields declined by 0.35% on U.S. treasuries, 0.08% on German bunds and 0.17% on Japan government bonds. Corporate bonds struggled to keep up with government bonds, as they were dragged down by financial issues and the Energy sub-sector. The sterling market was the worst performed. Spreads on US high-yield debt widened 0.21% but compressed 0.16% on European high-yield issues. Agency mortgage-backed securities outperformed treasuries by 0.10% and non-agency debt gained 0.5% to 2.0%, depending on the structure of the issue. Yields on peripheral European government debt widened relative to Germany. The S&P 500 lost 5% while European stocks lost over 1%. The price of oil rose after tumbling last month. The euro stabilized while the pound recovered some ground against the U.S. dollar. The Chinese yuan finished the month up 0.7%, its first meaningful move in two years.

## Performance

The Legg Mason Core Plus Global Bond Trust marginally outperformed its benchmark for the month. Portfolio performance over the past year was 7.9% ahead of benchmark.

Government bond yields declined and the portfolio's long duration, with a focus on intermediate maturity issues, had a positive impact on performance. Portfolio duration and curve positioning in the U.S. was the largest positive contributor to performance.

The portfolio's overweight to corporate debt, with an emphasis on the Financials sub-sector, detracted from performance as subordinated financial issues had a challenging month. An underweight allocation to agency mortgage-backed securities was neutral, while currency strategies were flat as the euro stabilised against the U.S. dollar.

## Outlook

Those who predict a double-dip recession often invoke the U.S. experience in the early 1980s. We find this an invalid inference, as the Volcker Federal Reserve purposefully engineered the U.S.'s second recession in 1981. The funds rate doubled, reaching 20% for a second time just months after the first of the double-dip recessions ended. Overall, 24 months of economic contraction were required to break the cycle of inflationary expectations that had solidified during the preceding decade. In contrast, monetary authorities today are engaged in unprecedented reflationary policies in a focused effort to stimulate growth. We expect gross domestic product growth to slow toward equilibrium growth rates in the next six months as the inventory restocking cycle concludes and fiscal stimulus fades. A second recession would additionally require a second shock. While we do not believe this is likely, candidate shocks include a second banking panic or premature fiscal consolidation.

Considering these potential shocks, today's global financial system is flush with central bank liquidity, benefits from government guarantees on liabilities and has access to unlimited dollars via official currency swap lines. Solvency has been bolstered by more than US\$1.5 trillion of capital injections. Further de-leveraging is necessary, particularly in Europe, but future liquidity crises should be minor and short-lived. As for premature fiscal consolidation, the pendulum has recently swung in favour of those who advocate an accelerated pace of deficit reduction.

This is somewhat concerning for risk assets, but monetary stimulus should be able to offset the scaling back of fiscal support. That said, monetary authorities will have to remain supportive for some time.

We are comfortable running additional duration and curve flattening strategies. We are managing these strategies tactically as both market pricing and underlying fundamentals change. For example, with government yields down substantially over the past two months, we have reduced duration positions closer to neutral in the U.S. and Europe. Conversely, we increased duration in the U.K. toward neutral despite falling yields as economic fundamentals have become more supportive of additional duration. The coalition government seems more unified than initially assumed and the emergency budget should help limit the government's cost of borrowing.

We continue to maintain an overweight to the Financials sub-sector, with a clear emphasis on globally diversified banks that are large and benefit from multiple sources of funding. Small regional banks with concentrated assets and single business lines are expected to struggle. We will continue to avoid these issues. Our preference is to gradually shift up the capital structure into more senior issues as pricing and market conditions warrant. Against this, we continue to run neutral to slightly underweight positions in the Industrials and Utilities sub-sectors. As has been the case for six months now, we look to also remain underweight agency mortgage-backed securities.

We find a number of smaller economies attractive, either on a yield or currency basis. We look to maintain a modest allocation to Polish interest rates as well as its currency. Poland's competitiveness vis-à-vis Germany remains strong and the country should continue to convergence toward eurozone living standards. We have implemented modest currency allocations, while limiting interest rate risk, to the Canadian dollar, Norwegian krona, Brazilian real, Indonesian rupiah, Korean won and Malaysian ringgit. The Canadian economy benefits from a sound banking system and its tightening cycle is further along. We believe Chinese yuan appreciation will continue and even gain. China's trading partners should continue to pressure China for further revaluation and China itself should increasingly benefit from revaluation. The biggest beneficiaries should be the handful of highly competitive Asian economies that trade extensively with China. They are in a strong position to capitalise during this phase as China transitions toward a more consumption-driven economic growth model. Against this, we continue to be pessimistic on the euro and view bouts of euro strength as selling opportunities.