

Market Commentary

The anxiety evident among investors at the beginning of August was misplaced as the month turned out to be a reasonably good one for stocks.

TOTAL RETURNS

	<u>August</u>	<u>QTD</u>	<u>YTD</u>
S&P 500 Index	+2.38%	+3.01%	+5.80%
Dow Industrials	+2.09%	+2.55%	+7.90%
Nasdaq Composite Index	+4.52%	+0.66%	-0.43%
S&P Mid-Cap 400 Index	+1.14%	-1.74%	+2.43%
Russell 2000 Index	+2.96%	-0.39%	+7.79%
Dow Jones Wilshire 5000 Index	+2.34%	+2.22%	+5.67%
S&P 100 Index	+2.59%	+4.33%	+7.26%
Russell 1000 Growth Index	+3.12%	+1.16%	+0.22%
Russell 1000 Value Index	+1.67%	+4.14%	+10.98%

Sources: Bloomberg, Wilshire, Russell

The strength in stocks in August was broad-based with only the S&P Mid-Cap and Russell 1000 Value indices returning less than 2%. In a notable change of form, the Nasdaq Composite Index was the star performer for the month on the strength of a rebound in tech stocks. Whether this improved performance signals the beginning of a change in investors' appetite for risk or merely bargain hunting in one of the most beaten down sectors of the market remains to be seen. Despite the strong rebound in August, the Nasdaq Composite remains the only major index that is still down year-to-date.

Viewed strictly on a probabilistic basis, investors should not have worried so much about an August decline. Since 1886, the Dow Industrials have been up 65% of the time in August, second in frequency only to December, which has shown gains over 70% of the time, according to market strategist Tony Dwyer (whose ultimate source is thechartstore.com). But, as our colleague Michael Mauboussin points out in his most recent piece, "Interdisciplinary Perspectives on Risk," human beings are not wired to think probabilistically. Our thinking tends to be very linear, and heavily influenced by recent events, especially so when the events are vivid.

For example, according to the website SixWise.com, the three ways of dying that people most fear are airplane crashes, shark attacks and being murdered. The odds of any of these actually happening is remote. According to Arnold Barnett, a statistical expert in the field of aviation safety, a person flying every day could expect to die in a plane crash once every 19,000 years. The odds of being attacked by a shark are one in 11.5 million, according to the International Shark Attack File (ISAF), which reports that only 1,909 confirmed shark attacks occurred around the world between the years 1580 and 2003!

As far as being murdered is concerned, the World Health Organization (WHO) reports that over 500,000 people a year are murdered worldwide, making the odds of any one person being murdered less than one in 10,000. Obviously, certain life styles are riskier than others. If you are an inner-city drug dealer, your chances of being murdered are probably a lot higher than one in 10,000; if not, they're probably considerably lower.

For the record, the three leading causes of death in the United States according to the *Journal of the American Medical Association* are smoking, poor diet and physical inactivity, and excessive alcohol consumption.

Our point in discussing the ways of dying that people fear most versus the ways of dying that are most likely to be relevant to their lives is that people often tend to worry about the wrong things. In early August, two of people's chief worries—as evidenced by their prominence in CNBC's *Squawk Box* reporting—were power outages and hurricanes. Neither is a high-probability event, but both received considerable airtime because if they did occur, their impact could be severe and, therefore, newsworthy.

In our view, the principal reason that August was a stronger month than many had expected was the market's favorable response to the Fed's decision to put further rate increases on hold for the time being. The long end of the bond market joined the stock market in signaling its approval of the Fed's decision. By month end, the 10-year US Treasury note's yield had dropped to about 4.72%, more than 50 basis points lower than its late June 2006 peak of 5.25%. The drop in yield suggests to us that the bond market is not especially worried about inflation and could pave the way for lower yields at the short end of the yield curve sometime next year. The Fed funds futures market is now betting that the Fed will remain on hold through year-end 2006. That strikes us as the correct stance as well. Economic growth—led by a downturn in housing—definitely appears to be slowing. In addition to housing, other signs of weakness include a slowdown in payroll employment growth in August to 1.3% year-over-year, a new low for this cycle. In addition, vehicle sales declined to a weaker-than-expected 16.1 million annualized rate. Auto production in the fourth quarter is now scheduled to decline at a 32% annualized rate, suggesting that real GDP may drop below 2% in the year's final quarter, according to Ed Hyman, Chairman and Chief Economist at ISI Group.

All things considered, we believe the Fed will conclude over the next few months that its work is finished for this tightening cycle. We believe the combined effects of 425 basis points of tightening at the short end of the yield curve and the 68% increase in 10-year US Treasury yields from 3.13% in June 2003 to 5.25% in June 2006 will be sufficient to slow real GDP growth meaningfully.

If it's true that the Fed is finished tightening, what does that imply for the equity market going forward? While our view has been that it would be a positive, the historical record on the subject is not especially encouraging. According to Ned Davis Research, Inc., from the end date of the last 13 tightening cycles (going back to 1929), the S&P 500 Index has been down 10 times and up 3 in the ensuing six months, and down 9 times and up 4 in the next twelve months. The average decline for six months was 4.98%, while for twelve months it was 3.34%, as detailed below:

Fed Tightening End Date	S&P 500 PCT. CHANGE		
	6 Mos. Later	12 Mos. Later	Recession Followed
8/9/1929	-24.24%	-29.21%	Y
10/16/1931	-23.17%	-26.64%	Y
1/16/1953	-7.07%	-1.31%	Y
8/23/1957	-8.67%	7.23%	Y
9/11/1959	-5.38%	-2.80%	Y
12/6/1965	-5.71%	-11.43%	N
4/3/1969	-7.44%	-11.84%	Y
4/25/1974	-20.70%	-3.94%	Y
2/15/1980	8.93%	10.74%	Y
5/5/1981	-4.70%	-9.87%	Y
2/24/1989	22.43%	12.89%	N
2/1/1995	18.79%	35.21%	N
5/16/2000	-7.83%	-12.35%	Y
6/29/2006?	?	?	?
Mean	-4.98%	-3.34%	
Median	-7.07%	-3.94%	

Source: Ned Davis Research, Inc. & Strategas Research Partners LLC

The negative median and average returns in the chart above are heavily influenced by the Great Depression and the bear market of 1974. More recent experience has been more favorable. The S&P 500 has been up six and twelve months after three of the last five tightening cycles have ended, averaging gains of 7.5% and 7.3% over those periods, respectively. As the chart above also indicates, the economy has often dipped into recession following the end of a tightening cycle. When it did not—as we think it won't this time around—the market tended to perform well, up sharply two times and down moderately the other. Assuming that the Fed's latest tightening cycle ended on June 29, 2006, the S&P 500 is off to a promising start, up 2.8% from that date through the end of August.

Outlook

Having survived August in better shape than many expected, we now turn our attention to September, where the long-term record and our own recent experience suggest reason

for caution. Historically, September has been the weakest month of the year, and the only one in which the Dow has shown negative returns on average since the 20th century began. Going back even farther, since 1886, the Dow Industrials have only been up about 42% of the time in September, compared to an average of 58% of the time for the other eleven months. We have speculated in past commentaries about the reasons that September has been weak more often than not, but have been unable to draw any firm conclusions. The odds may be especially stacked in favor of September being weak this year, since August was so strong. According to market strategist Bob Farrell, in the fifteen years since the late 1960s that the DJIA gained 1.8% or more in August (as it did this year), the month of September showed a loss every time.

One potential source of weakness in September could be nervousness about the outcome of the upcoming mid-term elections. President Bush's approval ratings remain in the high 30s. A majority of Americans now believe that the Iraq war was a mistake, and there is a growing perception that the benefits of the economic expansion have been unduly tilted toward corporations and the richest 1% of the population. This perception is bolstered by the fact that median family income is still below its level at the trough of the last recession, despite four years of strong output growth. Democrats are hoping to galvanize popular discontent to win back the House and make inroads in the Senate. Late last month, the betting on Tradesports.com was that the Republicans had about a 79% chance of retaining control of the Senate, but that it was now more likely than not (53.5%/46.5%) that they would lose control of the House. The exact implications of a Democratic takeover of the House are not completely clear, but it is certain that the agenda of the House would change materially as the takeover—should it occur—would usher in a cadre of new, liberal-leaning committee chairs, including Charles Rangel (D-NY) for Ways and Means, John Dingell (D-MI) for Energy and Commerce, Barney Frank (D-MA) for Financial Services and John Conyers (D-MI) for Judiciary.

For the sake of argument, let's assume that the market will be down in September. If so, how bad will it be, and what will happen next? We continue to expect any decline to be moderate, and therefore "buyable," and believe that the market is setting up for a worthwhile advance in the fourth quarter, one that carries over in a meaningful way into 2007.

The reason we continue to be relatively constructive on the outlook for equities is that we believe the *circumstances* of the current environment suggest that this is the correct view to hold. Michael Mauboussin's recent piece entitled "How Do You Compare?" discusses in some detail the relative merits of attribute-based versus circumstance-based thinking. We commend the piece to your attention if you haven't already seen it. Michael's main point on this issue is that attribute-based thinking tends to work best in static environments where nothing changes very much. When the environment is continually evolving and changing—as is true of the stock market—circumstance-based approaches are preferable, in his view.

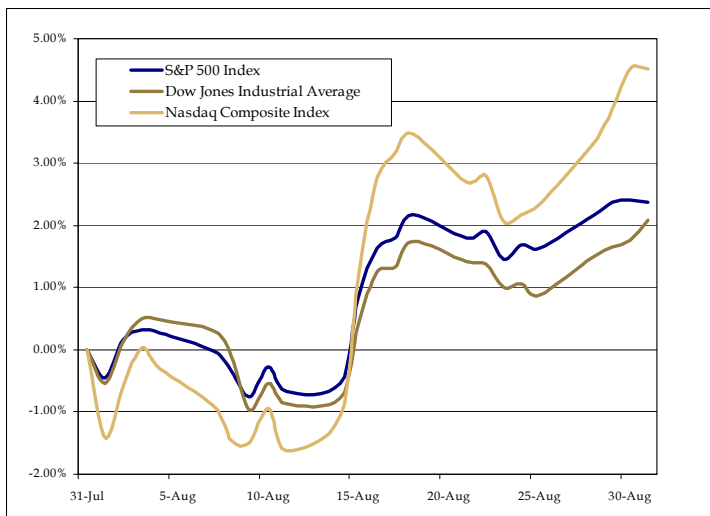
Webster defines “circumstance” as “a piece of evidence that indicates the probability or improbability of an event,” or alternatively, “the sum of essential and environmental factors.” Within that definition, what, then, are the market’s most relevant current circumstances? We see them as follows: (1) corporate balance sheets are flush with cash, (2) free cash flow margins are at, or near, record levels, (3) corporate profit growth continues to exceed expectations, (4) valuation levels are, at worst, reasonable, and arguably attractive, (5) private equity transactions and merger and acquisition activity are at record levels, suggesting that deep-pocketed investors see value in the market, (6) corporate share buybacks are at record levels, suggesting that management also sees value, (7) sentiment remains generally cautious, with domestic equity funds continuing to experience net outflows, (8) the possibility of a decline in the market in the September/October timeframe has been well telegraphed, giving investors ample opportunity to position themselves accordingly, if they so choose, (9) oil prices are 14% off their highs and seem likely to continue to moderate, and (10) 10-year US Treasury yields have fallen from 5.25% in June to 4.79% as of September 7, suggesting that the bond market is not especially worried about inflation, and raising (via a drop in the cost of capital) our estimate of the justifiable P/E of the stock market by over 8%, from 14.8x to 16.0x earnings, all other things being equal.

Despite the many real and imagined issues facing equity investors today, we believe the weight of the evidence supports a constructive view of the market, especially since, in our view, the positives get so much less attention than the negatives.

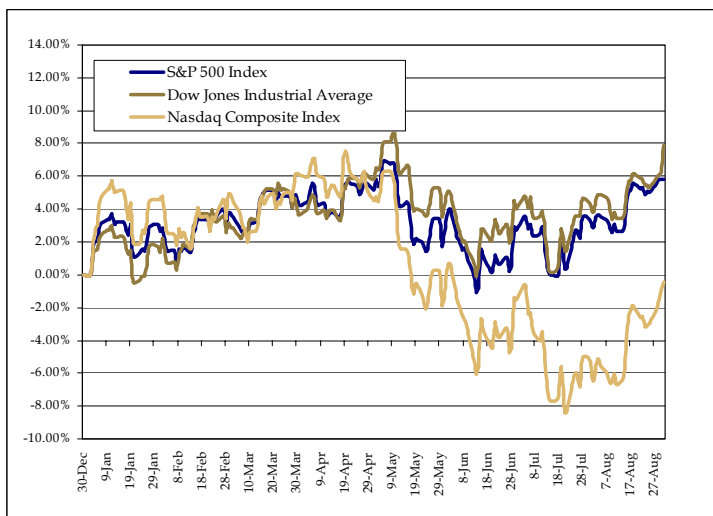
As always, we thank you for your support and welcome your comments.

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Chairman, Investment Policy Committee
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Major Indices August Performance



Major Indices YTD Performance



Source: Bloomberg and FactSet

Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	August	QTD	YTD
<i>Broad Market Indices</i>			
S&P 500	2.38	3.01	5.80
Dow Jones	2.09	2.55	7.90
Russell 1000	2.40	2.62	5.45
NASDAQ	4.52	0.66	(0.43)
Dow Jones Wilshire 5000	2.35	1.98	5.55
Russell 2000	2.96	(0.39)	7.79
Russell 1000 Growth	3.12	1.16	0.22
Russell 1000 Value	1.67	4.14	10.98
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	2.00	(1.43)	1.01
S&P 500 Consumer Staples	3.69	5.73	10.51
S&P 500 Energy	(3.79)	1.05	14.90
S&P 500 Financials	1.16	3.67	6.89
S&P 500 Health Care	3.00	8.66	4.54
S&P 500 Industrials	1.40	(3.95)	2.82
S&P 500 Information Technology	8.41	4.33	(1.78)
S&P 500 Materials	3.04	(0.53)	6.41
S&P 500 Telecomm Services	1.15	6.25	20.91
S&P 500 Utilities	2.84	7.90	12.72

Sources: Bloomberg, FactSet, Russell

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