

Market Commentary

Defying the historical odds and contrary to many observers' expectations, the US equity market posted a healthy gain in September. In fact, September's positive performance following on the heels of a strong August broke a record dating back almost 40 years. As noted in last month's commentary, in all 15 instances 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.

TOTAL RETURNS

	Sept	Q3	YTD
S&P 500 Index	+2.58%	+5.67%	+8.53%
Dow Industrials	+2.74%	+5.35%	+10.85%
Nasdaq Composite Index	+3.47%	+4.15%	+3.02%
S&P Mid-Cap 400 Index	+0.67%	-1.08%	+3.12%
Russell 2000 Index	+0.83%	+0.44%	+8.69%
Dow Jones Wilshire 5000 Index	+2.20%	+4.46%	+7.99%
S&P 100 Index	+3.11%	+7.58%	+10.60%
Russell 1000 Growth Index	+2.75%	+3.94%	+2.97%
Russell 1000 Value Index	+1.99%	+6.22%	+13.19%

Sources: Bloomberg, Wilshire, Russell

Large- and mega-cap stocks were the clear performance winners in September, as they were for the quarter as a whole. Small- and mid-cap stocks lagged in both periods. In our opinion, this trend is likely to persist for the remainder of this year and into 2007. Large and mega caps have been the superior values for some time, in our judgment. Now that they appear to have price momentum on their side, they will be hard to beat.

So why didn't the market go down in September as it was "supposed" to do? Very likely because if investors in aggregate expect market weakness, they position themselves accordingly beforehand, thus lessening the likelihood that what they expect to happen will actually occur.

Something like that definitely seems to have occurred this year. The market correction from May 5 to June 13 put investors in a foul mood and helped trigger the first substantial monthly outflows from domestic equity mutual funds since February 2003. It also appeared to cause most investors to ignore two indicators—spikes in the volatility index (VIX) and back-to-back 9-to-1 up volume days—that have in the past signaled better times ahead for the market. Once again this year, these signals have lived up to their reputation as harbingers of higher stock prices. The S&P 500 was up 7.7% in the three months following the latest VIX spike (6/13/06), right in line with its long-term average of 7.6%. The S&P 500 was also up 5% in

the three months following the second back-to-back 9-to-1 up volume day (6/29/06). Unfortunately, many investors were so focused on the downside in the market that they missed the rally.

Going into September, many—if not most—of the market strategists we read on a regular basis—Bob Farrell, Ned Davis, John Mendelson and Bob Brogan—remained either cautious or outright negative on the market outlook. For example, between August 11 and September 1, Ned Davis published a series of 10 hotlines describing the secular risks investors faced. Investors appeared to take this general mood of caution to heart and acted to protect themselves. A remarkable 17.5% of all NYSE trading volume in late August was short sales—by far the highest percentage on record. In addition, continuing the pattern set in May, net outflows from domestic equity mutual funds in the four months ended August were at their highest level since late 2002.

The enduring mood of investor caution and pessimism that has prevailed over the last several years is one of the reasons we have remained constructive on the equity market for much of that time period. This mood is well reflected in the UBS/Gallup Index of Investor Optimism tracked by Ned Davis and others. Not surprisingly to those who recognize sentiment as a contrary indicator, investor optimism as measured by the UBS/Gallup Index peaked in early 2000 along with the market, and bottomed in March 2003 at an important market low. More surprising, in our view, is the fact that in the 69 months since the end of 2000 (through September 2006), investors have only been classified as optimistic in seven, or just over 10% of the time. In the other 90% of months, they have either been neutral or outright pessimistic on the outlook for stocks. We find this remarkable since the bull market that began in October 2002 is celebrating its fourth birthday this month. That investors remain largely pessimistic four years into a bull market speaks to the powerful lingering effects of the bear market of 2000-2002 on investors' psyches.

As far as the economy is concerned, a slowdown definitely appears to have begun, led by a downturn in housing. New and existing home sales, housing starts and new orders are all well off their highs, while inventories of unsold homes are up substantially, and home prices have started to weaken. In a question-and-answer session following a speech before the Economic Club of Washington on October 4, Fed Chairman Ben Bernanke opined that a "substantial correction" in the US housing market is underway, but so far has not had a big effect on the rest of the economy. He noted that the slowdown would probably subtract "about one percentage point" from growth in the second half of this year and "probably something going into next year as well." Bernanke said that it was "very difficult" to predict how severe the downturn would be, but noted "strong fundamentals" underpinning the housing market, including low unemployment, rising wages and demographic shifts.

In our view, the fallout from the housing slowdown has been mitigated so far by a drop in mortgage rates and continued relatively high levels of cash-out refinancings. Though cash-out refis have dropped from an \$871 billion annualized rate in the third quarter of 2005, they were still running at an annualized rate of nearly \$500 billion in the second quarter of 2006, according to data developed by former Fed Chairman Alan Greenspan and Fed economist James Kennedy. Refi activity in September was also above expectations, apparently boosted by the drop in mortgage rates, many of which are tied to 10-year Treasury yields, which have dropped 65 basis points from 5.25% to 4.60% since June 2006. Consumer spending also appears to be buoyed by the recent rise in the stock market as well as the drop in energy prices, especially the price of gasoline.

Signs of economic weakness are not relegated to housing alone. New orders for manufactured goods were weak again in August, after being down in July. Perhaps more worrisome, the Institute of Supply Manufacturers (ISM) index of service sector activity fell sharply in September to 52.9 from 57 in August, its lowest level since April 2003 and well below expectations. Weakness in the service sector—the primary engine of job growth in the current recovery—is probably the main reason why US non-farm payroll growth was so weak in September.

The good thing about an economic slowdown—provided it doesn't get out of hand, and at this point we think it won't—is that it increases the probability that the Fed is finished tightening for this cycle. The Fed funds futures market is now pricing in a 98% probability that the Fed will leave the funds rate unchanged at 5.25% at its October 24 meeting, with a 2% probability that it will cut the rate 25 basis points to 5%. According to an analysis of futures pricing from Goldman Sachs, the probability of a rate cut rises to 10% at the December meeting and 26% by January 2007.

Outlook

We began 2006 believing that the US equity market could post low double-digit returns for the year. Midway through the year that didn't look like a very good bet, but following a quarter in which the Dow Industrials and S&P 500 Index were both up more than 5%, it's starting to look better. In fact, the S&P 500 needs only a total return of 1.5% in the fourth quarter to get to double-digits for the year, and the Dow Industrials and S&P 100 Index only have to hold their existing gains. If history is any guide, that shouldn't be a big problem. Over the last 20 years, the fourth quarter has been the strongest one for the S&P 500 Index, with an average total return of 5.06% and only three down quarters in 20. More recent performance has been even better. Over the last five years, the S&P 500 has returned an average of 8.53% in the fourth quarter, and an average of 8.22% over the last 10.

Our constructive attitude toward US equities is based on a number of factors, a key one of which is valuation. Based on the following assumptions, we think the S&P 500 Index is fairly valued at about 16.6 times earnings:

ASSUMPTIONS:

Long-term Earnings Growth Rate:	6.0%
Long-term Inflation Rate:	3.0%
Long-term Real GDP Growth Rate:	3.0%
Equity Risk Premium:	4.0%
Discount Rate (10-Year Treasury):	4.6%
Wgtd. Avg. Cost of Capital (WACC):	8.6%
Competitive Advantage Period (CAP):	20 yrs

On a capitalization-weighted, bottom-up basis, the S&P 500 is currently trading at about 15.5 times 2006 First Call Consensus earnings estimates, and 14.1 times corresponding estimates for 2007. Assuming that these estimates are reasonably accurate—and of course there is a risk that they're not—the market has about 7% upside to fair value based on 2006 estimates and about 18% upside through the end of next year based on 2007 estimates.

If the S&P 500 does approach our estimate of fair value by the end of 2007, it will trade somewhere in the low to mid 1500s, or not meaningfully higher than its all-time high of 1527 reached on March 24, 2000. For the sake of argument, let's say the S&P 500 does return to its old high by March 2008. If it does so, the eight-year total return from the old high will have been between 1% and 2% compounded, consisting only of dividend income. The real return will have been negative.

We make this point because we have heard the Calvinistic sort of secular bear argument that we investors were “bad” in the 1980s and 1990s and we must pay for our “sins” with an extended period of sub-par returns. Our view is that the bears need to wake up. We're six-plus years into a period of sub-par returns, and even if the market goes up 15% to 20% over the next 18 months, the long-term returns will *still* be sub-par, particularly after considering the effects of inflation.

The main risk to our constructive view of equities is that the current economic slowdown will morph into a recession and corporate profit growth will slow or turn negative. Year-to-year corporate profit growth has exceeded 10% for 17 consecutive quarters, with analysts consistently underestimating its strength. At some point, growth will slow and analysts' expectations will prove too optimistic. We don't yet see trouble on the horizon, but we are watching the trend of earnings very carefully.

Apart from corporate profit growth, the other key risk to our bullish view of stocks is interest rates. A move in 10-year Treasury yields from the current 4.60% back to the 5.25% level that prevailed in June would reduce the fair value earnings multiple of the S&P 500 from 16.6 times to 14.8 times. All else equal, that would make the market about 5% overvalued based on 2006 estimates and only about 5% undervalued on next year's estimates.

We should note that interest rates and profit growth rates are likely to impact fair value estimates in opposite directions. If the economy and profit growth slow, long rates are more likely to fall than rise, in our view, thus mitigating the negative effect of weaker

profits. On the other hand, if long rates rise, it will probably be because the economy and corporate profit growth remain healthy.

Before closing, we'd like to update clients on a study we published last month on the performance of the market following the end of Fed tightening cycles. The statistics we cited were from Ned Davis Research, which showed that in the 13 tightening cycles since 1929, the market was down an average of 4.98% six months after the tightening cycle ended, and down an average of 3.34% in the 12 months following. In terms of frequency, the market was down 10 times in six months, and up only three. In 12 months, it was down nine times and up four.

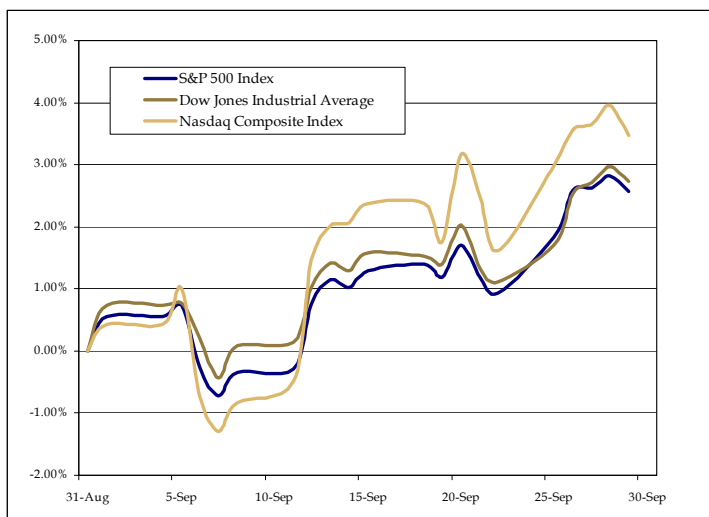
Shortly after publication, one of our colleagues noticed that a couple of tightening cycles in the mid-1980s appeared to have been omitted from Ned Davis Research's work. Upon further investigation, we discovered that prior to 1989 they used the discount rate rather than the Fed funds rate as the key indicator of Fed policy. To see if it mattered which rate one used, we did another study with data supplied by Bloomberg from 1971 to the present using the Fed funds rate throughout. Our results were substantially different than Ned Davis'. We found that following the end of the 12 tightening cycles since 1971, the market was up seven times and down five after both six and 12 months. The average gain for six months was 2.03%, while the average gain in the next 12 months was 4.89%.

Our primary conclusion from this work is that it is not possible to say conclusively what the market is likely to do following the end of a Fed tightening cycle, but that in recent history it has been more likely to help the market than hurt it.

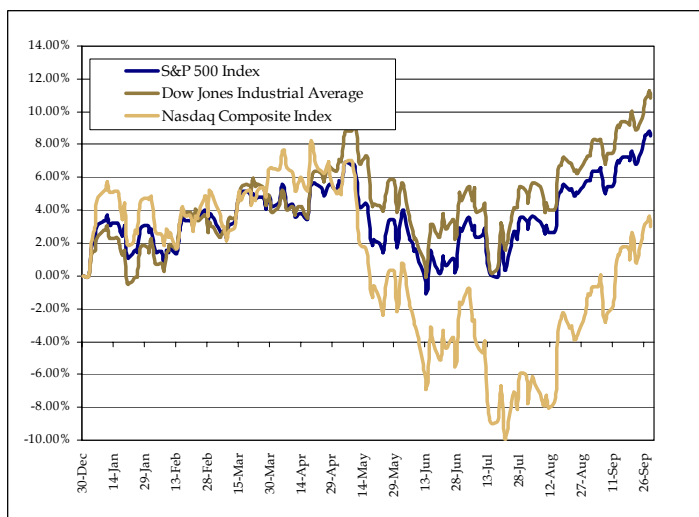
As always, we thank you for your support and welcome your comments.

David E. Nelson, CFA
Chairman, Investment Policy Committee
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Major Indices September Performance



Major Indices YTD Performance



Sources: Bloomberg and FactSet

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Monthly U.S. Market Update (Total Returns)

Sector Index Name	September	Q3	YTD
<i>Broad Market Indices</i>			
S&P 500	2.58	5.67	8.53
Dow Jones	2.74	5.35	10.85
Russell 1000	2.37	5.06	7.95
NASDAQ	3.47	4.15	3.02
Dow Jones Wilshire 5000	2.20	4.46	7.99
Russell 2000	0.83	0.44	8.69
Russell 1000 Growth	2.75	3.94	2.97
Russell 1000 Value	1.99	6.22	13.19
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	6.51	4.99	7.59
S&P 500 Consumer Staples	(0.04)	5.69	10.47
S&P 500 Energy	(2.76)	(1.74)	11.73
S&P 500 Financials	4.17	7.99	11.35
S&P 500 Health Care	1.43	10.22	6.03
S&P 500 Industrials	4.02	(0.10)	6.95
S&P 500 Information Technology	4.02	8.52	2.16
S&P 500 Materials	0.04	(0.49)	6.45
S&P 500 Telecomm Services	4.10	10.60	25.86
S&P 500 Utilities	(1.66)	6.11	10.85

Sources: Bloomberg, FactSet, Russell

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