February 2007

Market Commentary

The U.S. equity market got mugged on Tuesday, February 27, as all major market indices were down more than 3% on that date. Market declines of this breadth and magnitude are rare, and Tuesday's bloodbath was the worst single-day decline in nearly four years, since March 24, 2003. Based on pricing data from Bloomberg going back to 1955, we identified only 29 prior instances in which the Dow Industrials, the S&P 500 Index and the Nasdaq Composite were all down 3% or more in a single trading session, for a frequency of about once every 1 3/4 years. So, by historical standards, a single-day decline of February 27's severity was overdue by about two years.

TOTAL RETURNS

	Feb	YTD
S&P 500 Index	-1.96%	-0.47%
Dow Industrials	-2.52%	-1.16%
Nasdaq Composite Index	-1.85%	+0.15%
S&P Mid-Cap 400 Index	+0.73%	+4.39%
Russell 2000 Index	-0.79%	+0.87%
Dow Jones Wilshire 5000 Index	-1.57%	+0.30%
S&P 100 Index	-3.16%	-2.10%
Russell 1000 Growth Index	-1.88%	+0.64%
Russell 1000 Value Index	-1.56%	-0.30%

Sources: Bloomberg, Wilshire, Russell

For the month as a whole, all major market indices posted negative returns except for the S&P 400 Mid-Cap Index, which was clearly the star performer. Our expectations that large- and especially mega-cap stocks would give a better account of themselves in 2007 are so far not being met. The S&P 100 Index – a mega-cap proxy – was, in fact, the worst performing major market index for both the month of February and the year-to-date period. One need look no further than the ten largest companies in the S&P 100 Index by market value to find the culprits in this poor showing. Of these ten companies – which together account for over a third of the value of the S&P 100 Index – only one, AT&T Inc., was up through the end of February. The group was down 4.1% on average and 4.5% on a capitalization-weighted basis. We find this performance to be very surprising, since the top ten stocks on average have lower P/E ratios, higher dividend yields, comparable expected earnings growth and higher returns on equity than the market as a whole. We would expect these favorable qualities to assert themselves as the year progresses, and we, therefore, continue to believe that mega caps represent an attractive area for new investment.

The proximate cause of February 27's sell-off was widely postulated to be the 9% plunge in Chinese stocks in Shanghai earlier in the day. Other market observers attributed the decline to concerns raised when former Fed Chairman Alan Greenspan noted in response to a question following a speech in Hong Kong that a U.S. recession was "possible" in the latter part of 2007. We regard both of these explanations as plausible but certainly not definitive. An equally plausible explanation, in our opinion, is that the market was simply overdue for a correction, and got one. Veteran market technician John Mendelson was in our offices on February 23 making precisely that argument. In the meeting, Mendelson noted that the S&P 500 was more "extended" on the upside than at any time since January 2004, and that he expected a near-term pullback in the market, a "May-June 2006 type correction," as he described it. Mendelson measures the degree of market "extendedness" by the distance that a particular index trades above or below its 200-day moving average. According to his "Rubber Band Theory," when an individual stock or market index gets too extended on the upside or downside, it tends to "snap back" sharply in the other direction. It only took two trading days for John to be proved right, so he is either very good or very lucky. Either way, we tip our hat to him.

Since February 27's market rout, we have been asked by a number of clients and contacts in the media for our opinion of the significance, if any, of the market's decline. Is it a harbinger of recession, or of the beginning of a bear market? Of course, we cannot know for sure, but our view is that it is neither. One need only look back to the last such severe decline in March 2003 for reassurance. That 3% single-day decline in the major market indices was followed by a four-year bull market. The historical evidence looking back even further is also quite encouraging. We found that in the 29 instances since 1955 when the Dow, the S&P 500 and the Nasdaq Composite were all down 3% or more in a day, these indices all traded higher one year later about 80% of the time, showing average price gains over that time frame of between 14% and 15% depending on the index. Our specific findings are presented below.

Market Performance Since 1955
Following Joint Single-Day Declines of 3% or More In the Dow, S&P 500 & Nasdaq Composite

	Dow Industrials	S&P 500 Index	Nasdaq Composite
Times Up	24	23	24
Times Down	5	6	5
Avg. 1-Yr. Price Gain	+15%	+15%	+14%

Source: Bloomberg

On the economic front, the evidence has been mixed enough in the last several months that market observers seem to be having trouble deciding whether the economy is weakening or strengthening. In early December, the weakening theory seemed to hold sway. Ten-year U.S. Treasury notes were yielding about 4.5% and the Fed funds futures market was pricing in as many as three 25-basis point rate cuts in 2007. Following the unexpectedly strong fourth-quarter 2006 GDP report in January (which we warned at the time might be revised downward), the strengthening theory gained currency. Ten-year U.S. Treasury yields backed up to nearly 5% and the Fed funds futures market priced all prospects for rate cuts in 2007 out of the market. The worry even surfaced that the Fed might need to start raising rates again.

Fears in January that the economic porridge might be "too hot" were replaced in February by renewed concern that it may be "too cold." The yield on the 10-year has fallen back into the 4.5% range and some prospect of Fed easing in 2007 has been priced back into the futures market.

A number of factors have contributed to renewed concerns that the risks to the economic outlook may be more weighted to the downside. First, fourth-quarter real GDP growth was, as we suspected it might be, revised downward from 3.5% to 2.2%, and recently released economic data has tended more toward the weak side. Second, expectations for corporate profit growth have continued to moderate. Bottom-up, capitalization-weighted consensus earnings per share growth for the S&P 500 Index has dropped from over 9% early in the year to just under 8% currently. In addition, through late February, 74 companies in the S&P 500 Index had pre-announced first-quarter 2007 earnings expectations below consensus, while only 21 had said they expected to beat analysts' estimates, according to Thomson Financial. The 3.5-to-1 ratio of companies with lower-than-expected versus higher-than-expected forecasts is the highest since the third quarter of 2001, and compares to a long-term average of 2-to-1 on this measure.

The third and perhaps most significant factor contributing to worries about a weakening economic outlook is the recent turmoil in the subprime mortgage market. While the full implications are not yet clear, the situation is getting pretty ugly. Spreads on subprime loans have widened dramatically in the last month or so and a number of subprime lenders' stocks have collapsed. Concerns about these subprime lenders have broadened in the last week or two to include the larger mortgage lenders, as well as the major money center and investment banks, most of whom have large mortgage operations and many of whom have extended lines of credit to subprime lenders. In our view, this evolving situation warrants careful attention.

The concerns noted above may help explain why former Fed Chairman Alan Greenspan has used the "R" (for recession) word twice in the last week. The first time was in response to a question in Hong Kong on February 27. The second time was yesterday (3/5/07) when Greenspan was quoted as putting the odds of a U.S. recession in 2007 at one-in-three. To this point, we have not believed that the odds were that high, and we still don't, but we must admit that his comments have gotten us thinking.

Recessions are notoriously difficult to predict, and more are forecast than actually occur. The standard joke is that economists have predicted nine of the last five recessions. Another joke is that economists were invented to make fortune-tellers, astrologers and meteorologists look good. Their collective spotty forecasting record notwithstanding, when an economist of Mr. Greenspan's stature says he sees a one-third chance of recession this year, it seems only prudent to factor that into our thinking.

Outlook

Despite the recent setback in the market and the fact that the S&P 500 Index is now down year-to-date, we remain constructive on the outlook for the U.S. equity market for the balance of 2007, and expect the S&P 500 and other major market indices to post respectable gains for the year when all is said and done.

In our view, a market correction was long overdue and is basically healthy. The market was stretched on the upside, and the sell-off is acting to relieve that condition. With all leading stock indices having pulled back toward their 200-day moving averages, but all still trading above them, the technical condition of the market remains quite healthy, according to Ned Davis Research. Or to put it in John Mendelson's parlance, the "Rubber Band" has snapped back into place.

How long the correction will last or how deep it will go is anyone's guess. Our thought is that from its February 20, 2007, high of 1459.68, a reasonable downside target for the S&P 500 Index might be its 200-day moving average of 1345.51, implying a correction on the order of 8% or so. Our best guess is that we are about half way through the correction in terms of percentage decline, but probably less so in terms of duration.

Our bullish stance on the market continues to be based upon expectations of moderate earnings growth plus dividends plus some degree of multiple expansion. Though consensus earnings growth expectations for the S&P 500 have declined in recent weeks, they remain within the range of our more subdued expectations. The decline in 10-year U.S. Treasury yields back toward 4.5% has relieved the pressure on fair-value P/E multiples that we noted last month when long rates backed up toward 5%. Our view that the S&P 500 Index is worth 17 times 2007 earnings, but trades at less than 15 times those figures, once again has strong mathematical support.

We are encouraged to note that the market sell-off has improved investor sentiment measures materially. In the topsy-turvy world of sentiment, it's bad (for the market) when investors are optimistic and good when they're not. Thus, the fact that Ned Davis Research's Daily Crowd Sentiment Composite has dropped quickly back into "Extreme Pessimism" territory is a healthy sign for the market.

Also healthy, we believe, is the spike in the Volatility Index (VIX) to a high of 19.01 on February 27 from the 11 level the day before. In the past, such spikes have normally coincided with intermediate-term market bottoms or attractive buying points.

In addition to the favorable valuation, earnings and sentiment underpinnings to the market, we also see a compelling supply/ demand case as well. Market strategist Jason Trennert, formerly of ISI Group and now out on his own as co-founder of Strategas Research Partners, LLC, makes this argument forcefully in a February

26, 2007, report entitled "The Base Case for a Melt-Up." In this piece, Trennert notes that net new equity issuance in 2006 was *minus* $600 billion (i.e., it contracted) at the same time that private equity firms raised $160 billion in new money. Leveraged at an assumed multiple of 4-to-1, this gives the private equity firms incremental buying power of $640 billion at the same time that the overall supply of equity is contracting. This strikes Jason—and us—as quite bullish.

As we hope the foregoing makes clear, we continue to believe that there are lots of reasons to be constructive on the outlook for the U.S. equity market. A minor concern is that there seem to be a lot of others who share that view. We've got to admit that makes us a little nervous.

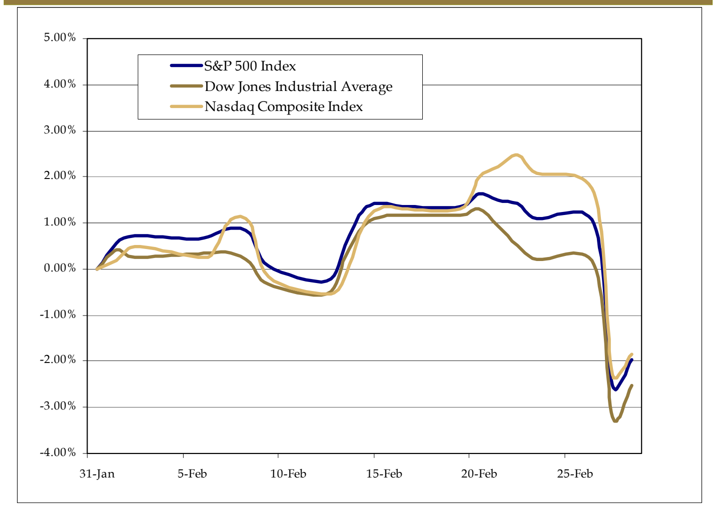
Since the correction began, and especially since the February 27 sell-off, we have seen a number of articles in both the *Wall Street Journal* and *New York Times* that were basically constructive on the market. *Barron's* also ran an article by Andrew Bary in its March 5, 2007, issue entitled "Still Betting on the Bull." In addition, the latest issue of *Business Week* (March 12, 2007) features a cover story entitled "What the Market Is Telling Us." The subtitle to the article reads: "Volatility is back. Ominous signs loom. But the outlook for the U.S. markets is surprisingly upbeat."

Each of these articles was well-written, persuasively argued, and made many of the same points as we have here. We basically think they are correct, but the nearly universally constructive post-sell-off commentary makes us suspicious that the market may have a surprise or two up its sleeve to shake investor confidence (and perhaps even our own) before resuming its advance.

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

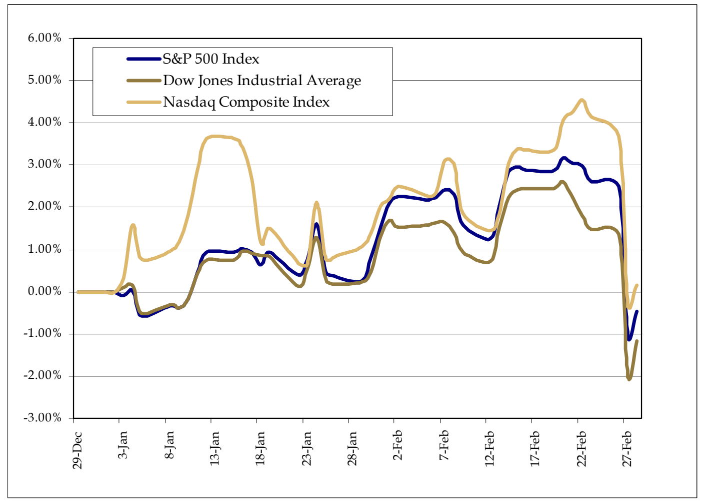
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices February Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	February	YTD
Broad Market Indices		
S&P 500	(1.96)	(0.47)
Dow Jones	(2.52)	(1.16)
Russell 1000	(1.72)	0.17
NASDAQ	(1.85)	0.15
Dow Jones Wilshire 5000	(1.57)	0.30
Russell 2000	(0.79)	0.87
Russell 1000 Growth	(1.88)	0.64
Russell 1000 Value	(1.56)	(0.30)
S&P 500 Sector Indices		
S&P 500 Consumer Discretionary	(2.95)	(0.25)
S&P 500 Consumer Staples	(1.66)	0.29
S&P 500 Energy	(1.95)	(3.75)
S&P 500 Financials	(2.98)	(2.12)
S&P 500 Health Care	(2.26)	0.76
S&P 500 Industrials	(1.13)	0.19
S&P 500 Information Technology	(3.04)	(1.51)
S&P 500 Materials	2.23	6.93
S&P 500 Telecomm Services	(0.66)	3.21
S&P 500 Utilities	5.29	4.98

Sources: Bloomberg, FactSet, Russell